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COMMENT

Variations in the Marketable-Product Rule from State to State

I. Introduction

Disputes pertaining to the proper calculation of gas royalty payments have led to much litigation and diverse case law. Many of these disputes concern the point at which the price of gas is valued for royalty payment purposes. The point at which royalty valuation occurs involves a determination of how the gas is valued and whether certain post-extraction costs may be deducted.¹ This article focuses on the second factor, the allocation of post-extraction costs.

Post-extraction costs are those incurred after gas is extracted from the wellhead.² The deductibility of post-extraction costs from a lessor's royalty payment is a state specific and instrument-specific inquiry. This inquiry requires consideration of a state's particular treatment of the "at the well" phrase, as well as the extent of the lessee's duties under the implied covenant to market.

The issue of post-extraction deductions has led to multiple class-action lawsuits filed by disgruntled lessors claiming that their royalties were underpaid due to the lessee's improper deduction of costs.³ Furthermore, these lawsuits will continue because of uncertainties and variations in the courts' treatment of post-extraction costs and "at the well" terminology in royalty provisions. In addition, a state's rule regarding post-extraction costs affects the drafting of royalty provisions in oil and gas leases, because parties may contract around a state's default rule on the allocation of post-extraction costs.⁴

1. 3 EUGENE KUNTZ, LAW OF OIL & GAS §§ 40.4(d), 42.2 (1989) (determination of market value for purposes of paying gas royalty); *id.* § 40.4(3) (determination of proceeds deductions); *see also* *Martin v. Glass*, 571 F. Supp. 1406, 1410 (N.D. Tex. 1983), *aff'd*, 736 F.2d 1524 (5th Cir. 1984); Scott Lansdown, *The Marketable Condition Rule*, 44 S. TEX. L. REV. 667, 670 (2003).

2. KUNTZ, *supra* note 1, § 40.5; *see also* Owen L. Anderson, *Royalty Valuation: Should Royalty Obligations Be Determined Intrinsically, Theoretically, or Realistically?* (pt. 2), 37 NAT. RESOURCES J. 611, 627 (1997) (quoting *Piney Woods Country Life Sch. v. Shell Oil Co.*, 726 F.2d 225, 240 (5th Cir. 1984)).

3. *See* *Rogers v. Westerman Farm Co.*, 29 P.3d 887 (Colo. 2001); *Sternberger v. Marathon Oil Co.*, 894 P.2d 788 (Kan. 1995); *Mittelstaedt v. Santa Fe Minerals, Inc.*, 1998 OK 7, 954 P.2d 1203; *Estate of Tawney v. Columbia Natural Res., L.L.C.*, 633 S.E.2d 22 (W. Va. 2006).

4. *See* *Garman v. Conoco, Inc.*, 886 P.2d 652, 657 (Colo. 1994); *Martin*, 571 F. Supp. at 1410.

In many states, however, it remains unclear what language the courts will deem sufficient to allocate these costs.⁵

Two general rules address post-extraction deductions: the at-the-well rule and the marketable-product rule.⁶ In states adhering to the at-the-well rule, all post-extraction costs may be deducted.⁷ Conversely, in states adhering to the marketable-product rule, the deductibility of particular post-extraction costs is unclear and varies somewhat from state to state.⁸ At least two states that adhere to the marketable-product rule have modified the general approach beyond the view of treatise writers.⁹ This has resulted in a wide spectrum of marketable-product rules, with differing results as to the deductibility of post-extraction costs under each specific state's rule. Rather than critique and criticize the various rules, as so many have already done,¹⁰ this article seeks to shine some light on the uncertainties of the marketable-product rule.

The purpose of this comment is to compare the case law in states that adhere to the marketable-product rule, and to analyze how these states differ in their specific application of the rule. Part II provides an overview of the law applicable to royalties, royalty clause language, and post-extraction costs. Part III examines the case law of five states adhering to some version of the marketable-product rule. Part IV compares and contrasts these five state variations of the marketable-product rule, as well as discussing some of the problems inherent in the rules. This comment concludes in Part V.

5. See, e.g., *Heritage Res., Inc. v. NationsBank*, 939 S.W.2d 118 (Tex. 1996) (holding that an "at the well" phrase trumped an express no-deductions clause); *Tawney*, 633 S.E.2d 22 (holding that an "at the well" phrase was insufficient to allocate post-extraction costs).

6. See Owen L. Anderson, *Royalty Valuation: Calculating Freight in a Marketable-Product Jurisdiction*, 20 ENERGY & MINERAL L. INST. 331, 338 (2000); Adam Marshall, Note, *Oil & Gas Law: Royalty Valuation: Rogers v. Westerman Farm Co.: Burdening Lessees with an Implied Duty to Deliver Gas to a Marketable Location*, 56 OKLA. L. REV. 233, 235 (2003).

7. See *Piney Woods*, 726 F.2d 225; *Martin*, 571 F. Supp. at 1412; *Schroeder v. Terra Energy, Ltd.*, 565 N.W.2d 887 (Mich. Ct. App. 1997); *Heritage Res.*, 939 S.W.2d 118.

8. See Owen L. Anderson, *Royalty Valuation: Should Overriding Royalty Interests and Nonparticipating Royalty Interests, Whether Payable in Value or in Kind, Be Subject to the Same Valuation Standard as Lease Royalty?*, 35 LAND & WATER L. REV. 1, 3 (2000); see also *Rogers*, 29 P.3d 887; *Sternberger*, 894 P.2d 788; *Mittelstaedt*, 1998 OK 7, 954 P.2d 1203; *Tawney*, 633 S.E.2d 22.

9. See *Rogers*, 29 P.3d 887; *Tawney*, 633 S.E.2d 22.

10. See, e.g., Byron C. Keeling & Carolyn King Gillespie, *The First Marketable Product Doctrine: Just What Is the "Product"?*, 37 ST. MARY'S L.J. 1, 21 (2005); David Pierce, *Developments in Nonregulatory Oil and Gas Law: The Continuing Search for Analytical Foundations*, 47 INST. ON OIL & GAS L. & TAX'N, 1-1, 1-43 to -48 (1996); Edward B. Poitevent, II, *Post-Production Deductions from Royalty*, 44 S. TEX. L. REV. 709, 714 (2003).

II. The Royalty, Royalty Clause Language, and the Rules Regarding Post-Extraction Cost

A. Royalty Valuation Basics

A royalty is created when a mineral owner leases her oil and gas rights retaining a risk-free, noncost bearing interest in oil and gas produced and saved from the leased property.¹¹ A royalty is usually the primary consideration, or benefit, received by a lessor in exchange for granting a lease.¹² Generally, royalty provisions are construed as being free of all costs incurred in bringing about “production” of oil and gas¹³ and are payable either “in kind” or “in cash.”¹⁴ If a royalty clause states that the royalty owner is to be paid in either oil or gas, the royalty is “in kind,” and entitles the royalty owner to receive his proportionate share of the mineral produced.¹⁵ If the royalty clause states that the royalty owner is to be paid a sum of money, the royalty is “in cash,” and entitles the royalty owner to receive a sum of money which is usually related to the value of the gas.¹⁶ Typically, royalty clauses have separate provisions for oil and gas.¹⁷ Oil is often payable “in kind”¹⁸ and gas is almost always payable “in cash.”¹⁹ This different treatment results from the physical differences between the two products. Oil, being a liquid, can be separated at the well site and the royalty owner can physically receive her share.²⁰ Gas is more effectively marketed in bulk, and royalty owners cannot easily take their share at the well site.²¹ Even if the royalty clause calls for the royalty to be paid “in kind,” the royalty owner often waives the right to delivery “in kind” and receives payments in cash.²² When a royalty is payable

11. 1 HOWARD R. WILLIAMS & CHARLES J. MEYERS, OIL AND GAS LAW § 301 (2007).

12. Keeling & Gillespie, *supra* note 10, at 21.

13. 58 C.J.S. *Mines and Minerals* § 298 (2007); *see also* KUNTZ, *supra* note 1, § 40.5, at 351 (“Unquestionably, under most leases, the lessee must bear all costs of production.”).

14. *See* KUNTZ, *supra* note 1, § 38.2.

15. *Id.*

16. *Id.*

17. JOHN S. LOWE ET AL., CASES AND MATERIALS ON OIL AND GAS LAW 231 (John S. Lowe & Pauline M. Simmons eds., 4th ed. 2002); *see also* Keeling & Gillespie, *supra* note 10, at 9; Jefferson D. Stewart & David F. Maron, *Post-Production Charges to Royalty Interests: What Does the Contract Say and When Is It Ignored?*, 70 MISS. L.J. 625, 628 (2000).

18. LOWE ET AL., *supra* note 17, at 231; *see also* KUNTZ, *supra* note 1, § 39.2.

19. LOWE ET AL., *supra* note 17, at 231; *see also* KUNTZ, *supra* note 1, § 40.4(a); Poitevent, *supra* note 10, at 716.

20. LOWE ET AL., *supra* note 17, at 231; *see also* Poitevent, *supra* note 10, at 716.

21. LOWE ET AL., *supra* note 17, at 231.

22. KUNTZ, *supra* note 1, §§ 39.2(c), 40.3(c).

“in cash,” the royalty-valuation point must be ascertained for purposes of calculating royalty.²³

The royalty-valuation point refers to the point at which the value of oil or gas is fixed for the purpose of calculating a lessor’s royalty payment.²⁴ The point at which royalty valuation occurs involves a determination of the amount, as established by the lease, on which royalty is to be paid, as well as the deductions that may be taken.²⁵ The amount of royalty payable usually depends first on whether the lease requires royalty to be paid on proceeds or on an implicit market value of the product.²⁶ This is determined by the language of the royalty clause.²⁷ Courts’ interpretation of the language, however, varies from state to state.²⁸

The next step involves the determination of what deductions, if any, may be taken from the amount on which royalty is to be paid.²⁹ The deductions allowed depend on a specific state’s rule regarding post-extraction costs.³⁰ For example, in a “proceeds at the well” lease, if a lessee is allowed to deduct transportation costs to a distant market, then royalty is paid on the proceeds received for the sale of gas, less deductions for the costs incurred in transporting the gas to the point of sale.³¹ Thus, the royalty-valuation point is the price of the gas before it was transported, and to determine this price the transportation costs are deducted from the proceeds.

Courts differ on whether the lessee can deduct post-extraction costs from the lessor’s royalty payment.³² Post-extraction costs are the costs incurred

23. See *Martin v. Glass*, 571 F. Supp. 1406, 1410 (N.D. Tex. 1983), *aff’d*, 736 F.2d 1524 (5th Cir. 1984); *Lansdown*, *supra* note 1, at 670.

24. See *Martin*, 571 F. Supp. at 1410; *Lansdown*, *supra* note 1, at 670.

25. See *Martin*, 571 F. Supp. at 1410; *Lansdown*, *supra* note 1, at 670.

26. KUNTZ, *supra* note 1, § 40.4(d) & (e).

27. *Id.* § 39.3(c); see also *Piney Woods Country Life Sch. v. Shell Oil Co.*, 726 F.2d 225, 233-38 (5th Cir. 1984) (distinguishing “market value” from “proceeds”).

28. See, e.g., *Piney Woods*, 726 F.2d at 233-38 (distinguishing “market value” from “proceeds”); *Roye Realty & Developing, Inc. v. Watson*, 1996 OK 93, 949 P.2d 1208; *Tex. Oil & Gas Corp. v. Vela*, 429 S.W.2d 886 (Tex. 1968); see also *Anderson*, *supra* note 2, at 614; Bruce M. Kramer, *Interpreting the Royalty Obligation by Looking at the Express Language: What a Novel Idea?*, 35 TEX. TECH. L. REV. 223, 241-52 (2004).

29. See *Keeling & Gillespie*, *supra* note 10, at 32-37; *Lansdown*, *supra* note 1, at 669.

30. It is important to note that the phrase “deductions from a lessor’s royalty payment” actually means deductions from the amount on which a lessor’s royalty payment is based. The lessor is not charged, and does not owe anything when deductions are taken. Instead, the lessor’s royalty payment is based on a lower amount, resulting in a lower royalty payment. See *Lansdown*, *supra* note 1, at 670; *Poitevent*, *supra* note 10, at 714.

31. See *Johnson v. Jernigan*, 1970 OK 180, 475 P.2d 396 (ruling that in Oklahoma, costs of transporting oil or gas to distant market can be deducted from royalty).

32. See *Rogers v. Westerman Farm Co.*, 29 P.3d 887 (Colo. 2001); *Sternberger v. Marathon*

after oil or gas is extracted from the wellhead.³³ These costs include gathering, transportation, compression, dehydration, separation, blending, treating, and processing.³⁴ Processing involves the extraction of natural gas liquids (NGLs), but the term processing is often more generally used by courts to describe various post-extraction operations.³⁵ When construing royalty clauses, the courts generally agree that extraction costs cannot be deducted when a lessee determines the royalty payable to a lessor; however, they do not agree on whether the various kinds of post-extraction costs are deductible.³⁶ The post-extraction-costs dispute often concerns the lessee's duties pursuant to the implied covenant to market as well as the sufficiency of "at the well" terminology contained in a lease royalty clause.³⁷ Unfortunately, current case law regarding post-extraction costs, the implied covenant to market, and the interpretation of "at the well" varies from state to state.

B. The Two Approaches to Post-Extraction Costs: The At-the-Well Rule and the Marketable-Product Rule

The two general approaches to the deduction of post-extraction costs are the at-the-well rule and the marketable-product rule.³⁸ While Texas, and perhaps a few other jurisdictions, have adopted the at-the-well rule,³⁹ more states have recently adopted some variation of the marketable-product rule.⁴⁰ Additionally, Michigan, Nevada, and Wyoming have adopted a statutory version of the marketable-product rule,⁴¹ and the United States has long followed this approach by statute and regulation.⁴² Under both rules, the lessee

Oil Co., 894 P.2d 788 (Kan. 1995); *Mittelstaedt v. Santa Fe Minerals, Inc.*, 1998 OK 7, 954 P.2d 1203; *Heritage Res., Inc. v. NationsBank*, 939 S.W.2d 118 (Tex. 1996).

33. KUNTZ, *supra* note 1, § 40.5.

34. See *Mittelstaedt*, ¶ 2, 954 P.2d at 1205; *Heritage Res.*, 939 S.W.2d at 122.

35. See KUNTZ, *supra* note 1, § 39.4 (processing used to describe various post-production operations); *id.* § 40.4 (processing used to describe extraction of substances from gas); *id.* § 40.5(b) (discussing processing of wet gas as the removal of NGLs).

36. See LOWE ET AL., *supra* note 17, at 263-70; 3 WILLIAMS & MEYERS, *supra* note 11, §§ 645, 645.1; see also *Mittelstaedt*, 1998 OK 7, 954 P.2d 1203; *Heritage Res.*, 939 S.W.2d 118.

37. See *Rogers*, 29 P.3d 887; *Sternberger*, 894 P.2d 788; *Mittelstaedt*, 1998 OK 7, 954 P.2d 1203; *Estate of Tawney v. Columbia Natural Res., L.L.C.*, 633 S.E.2d 22 (W. Va. 2006).

38. See *Anderson*, *supra* note 6, at 338; *Marshall*, *supra* note 6, at 235.

39. See *Wall v. United Gas Pub. Serv. Co.*, 152 So. 561, 564 (La. 1934); *Creson v. Amoco Prod. Co.*, 10 P.3d 853, 856 (N.M. Ct. App. 2000); *Heritage Res.*, 939 S.W.2d 118.

40. See *Rogers*, 29 P.3d 887; *Sternberger*, 894 P.2d 788; *Mittelstaedt*, 1998 OK 7, 954 P.2d 1203; *Tawney*, 633 S.E.2d 22.

41. MICH. COMP. LAWS ANN. § 324.61503(b) (West 1999); NEV. REV. STAT. ANN. § 522.115(b) (West 2000); WYO. STAT. ANN. § 30-5-304 (2007).

42. See Federal Oil and Gas Royalty Management Act of 1982, 30 U.S.C. §§ 1701-1758 (2000); see also 30 C.F.R. §§ 206.102, 206.103, 206.152-.154 (2007).

is responsible for all costs of exploration and production.⁴³ This is because the lessee, as the working interest owner, assumes the risk involved in developing the lease, including all costs incurred in the production of oil or gas from the leased premises.⁴⁴ Conversely, the lessor is not responsible for any costs incurred in production. The lessor bears only the indirect risk that no oil or gas will be found or, if found, that the lessee will not abide by the express or implied terms of the lease.⁴⁵ The two approaches disagree, however, on what costs the lessee is required to bear after extraction of the oil or gas from the wellhead. Pursuant to the at-the-well rule, the lessee may deduct all costs incurred after the oil or gas is severed from the wellhead.⁴⁶ In contrast, the marketable-product rule mandates that the lessee bear all costs incurred in obtaining a marketable product and disallows the deduction of post-extraction costs until a marketable product is obtained.⁴⁷ Under either rule, the actual presence or absence of “at the well” terminology in the royalty clause does not seem to matter.⁴⁸

1. *The Marketable-Product Rule*

Two bases for the marketable-product exist. The first, which has been relied on in most of the marketable-product states, is based on the implied covenant to market.⁴⁹ Although all major oil and gas producing states recognize the implied covenant to market, there is disagreement among the states as to what the covenant encompasses.⁵⁰ The implied covenant to market obligates a lessee to diligently seek a market for the oil or gas produced and, if royalty is due on the price received, to obtain the best price reasonably obtainable.⁵¹ The basic premise underlying the implied covenant to market is

43. Owen L. Anderson, *Calculating Royalty: “Costs” Subsequent to Production—“Figures Don’t Lie, but . . .”*, 33 WASHBURN L.J. 591, 591 (1994).

44. *Id.*

45. *Id.*

46. See *Martin v. Glass*, 571 F. Supp. 1406, 1411-12 (N.D. Tex. 1983), *aff’d*, 736 F.2d 1524 (5th Cir. 1984); see also *Heritage Res., Inc. v. NationsBank*, 939 S.W.2d 118, 122 (Tex. 1996).

47. See *Rogers v. Westerman Farm Co.*, 29 P.3d 887, 901 (Colo. 2001); *Sternberger v. Marathon Oil Co.*, 894 P.2d 788, 795 (Kan. 1995); *Mittelstaedt v. Santa Fe Minerals, Inc.*, 1998 OK 7, ¶ 2, 954 P.2d 1203, 1205; *Estate of Tawney v. Columbia Natural Res., L.L.C.*, 633 S.E.2d 22, 27-28 (W. Va. 2006).

48. See, e.g., *Martin*, 571 F. Supp. at 1412 (reading “at the well” language into the lease); *Tawney*, 633 S.E.2d 22 (ignoring the “at the well” language).

49. See *Rogers*, 29 P.3d 887; *Sternberger*, 894 P.2d 788; *Mittelstaedt*, 1998 OK 7, 954 P.2d 1203; *Tawney*, 633 S.E.2d 22.

50. See *Martin*, 571 F. Supp. 1406; *Rogers*, 29 P.3d 887; *Sternberger*, 894 P.2d 788; *Mittelstaedt*, 1998 OK 7, 954 P.2d 1203; *Tawney*, 633 S.E.2d 22.

51. *Mittelstaedt*, ¶ 2, 954 P.2d at 1211 (Opala, J., dissenting); see also Keeling & Gillespie,

to ensure that both lessee and lessor benefit from the lease relationship.⁵² The lessor's primary benefit in entering an oil and gas lease is to receive a royalty in exchange for leasing his mineral interest to the lessee.⁵³ Thus, the implied covenant to market protects the lessor's benefit by obligating the lessee to market its oil or gas production.⁵⁴ In states adhering to the marketable-product rule, the lessee's duty to market, pursuant to the implied covenant, includes the duty of preparing the product for market.⁵⁵

The late Professor Merrill asserted:

If it is the lessee's obligation to market the product, it seems necessarily to follow that his is the task also to prepare it for market, if it is unmerchantable in its natural form. No part of the costs of marketing or of preparation for sale is chargeable to the lessor.⁵⁶

Therefore, according to Professor Merrill, the implied covenant to market obligates a lessee to bear all costs incurred in obtaining a marketable product.⁵⁷ Accordingly, states adhering to the marketable-product rule have found that a lessee is obligated, pursuant to the implied covenant to market, to bear all costs incurred in transforming the oil or gas into a marketable product.⁵⁸ As a result, royalty valuation occurs at the point where the product becomes marketable, and post-extraction costs are not deductible until this point.⁵⁹ Additionally, some marketable-product states have extended the lessee's duty, pursuant to the implied covenant, to require the lessee to bear the costs of transporting the product to market.⁶⁰ Thus, a lack of consensus among the marketable-product jurisdictions exists regarding the lessee's duties and what costs the lessee is obligated to bear.

Contractual interpretation is the second basis for the marketable-product rule. Rather than base his assertion on the implied covenant to market, the late Professor Kuntz asserted that the express language of the typical oil and gas lease should be interpreted as requiring the lessee to bear all costs incurred in

supra note 10, at 21.

52. Keeling & Gillespie, *supra* note 10, at 21-23.

53. *Id.*

54. *Id.*

55. See Rogers, 29 P.3d 887; Sternberger, 894 P.2d 788; Mittelstaedt, 1998 OK 7, 954 P.2d 1203; Tawney, 633 S.E.2d 22.

56. MAURICE H. MERRILL, COVENANTS IMPLIED IN OIL AND GAS LEASES § 85, at 214-15 (2d ed. 1940) (footnotes omitted).

57. *Id.*

58. *Id.*

59. *Id.*

60. See Rogers, 29 P.3d at 900-01; Tawney, 633 S.E.2d at 22.

obtaining a marketable product.⁶¹ Under Kuntz's view, "production," as that term is used in an oil and gas lease, is not complete until a marketable product is obtained.⁶² Thus, the lessee is responsible for all costs incurred in obtaining a marketable product.

Under either Merrill's approach or Kuntz's approach, once a marketable product is obtained, post-extraction costs incurred to further enhance the product are deductible.⁶³ Although the two bases for the marketable-product rule vary as to the reason the lessee is required to bear all costs incurred in obtaining a marketable product, both views essentially produce the same result. Under either basis for the marketable-product rule, a lessee may not deduct any costs incurred after extraction of oil or gas from the well head that are necessary to create a marketable product. Furthermore, under the views of both Merrill and Kuntz, if there is no market for the product on the leased premises, the lessee may deduct from a lessor's royalty payment costs incurred in transporting the marketable product to a distant point of sale.⁶⁴ Most states adhering to the marketable-product rule have reached the conclusion that the lessee must obtain a marketable product based on the implied covenant to market, rather than on Kuntz's rule of contract construction.⁶⁵ However, two courts have reached their conclusion by citing Kuntz instead of Merrill.⁶⁶

2. *The At-the-Well Rule*

The at-the-well rule is based on a property law approach to royalty valuation, entitling the lessor to claim the royalty when the oil or gas is captured at the wellhead and converted from real property to personal property.⁶⁷ At-the-well jurisdictions recognize the implied covenant to market, however, in these jurisdictions the lessee's only obligation under the covenant is to diligently market production and obtain the best possible terms and price.⁶⁸ As a result, under the at-the-well rule, a lessee's duty to market does not require that the lessee bear all costs of preparing the product for market.⁶⁹ Courts embracing the at-the-well rule place little or no importance on the

61. KUNTZ, *supra* note 1, § 40.5; *see also* Lansdown, *supra* note 1, at 681.

62. KUNTZ, *supra* note 1, § 42.2; *see also* Lansdown, *supra* note 1, at 681.

63. KUNTZ, *supra* note 1, § 42.2; MERRILL, *supra* note 56, § 86.

64. KUNTZ, *supra* note 1, § 42.2; MERRILL, *supra* note 56, § 86.

65. *See Rogers*, 29 P.3d 887; *Sternberger v. Marathon Oil Co.*, 894 P.2d 788 (Kan. 1995); *Mittelstaedt v. Santa Fe Minerals, Inc.*, 1998 OK 7, 954 P.2d 1203; *Tawney*, 633 S.E.2d 22.

66. *See Rogers*, 29 P.3d 887; *Mittelstaedt*, 1998 OK 7, 954 P.2d 1203.

67. Owen L. Anderson, *Royalty Valuation: Should Royalty Obligations Be Determined Intrinsically, Theoretically, or Realistically?* (pt. 1), 37 NAT. RESOURCES J. 547, 572 (1997).

68. Poitevent, *supra* note 10, at 713-14.

69. *Id.*

condition of the product upon extraction.⁷⁰ Instead of evaluating the quality of the product, these courts use the point at which the product was severed from the wellhead as the place for valuing the royalty.⁷¹ Accordingly, all costs incurred after severance of the oil or gas from the wellhead are post-production costs that can be proportionately deducted from a lessor's royalty.⁷²

3. The Sufficiency of "At the Well" Terminology in Allocating Post-Extraction Costs

The default approach followed by a jurisdiction affects how the "at the well" phrase in a gas royalty clause is construed. Under the at-the-well rule, as applied in Texas, courts construe the "at the well" phrase and similar terminology as allocating all post-extraction costs at the point of severance regardless of the marketability of the gas at that point and, generally, regardless of other language in the royalty clauses that may suggest that some post-extraction costs cannot be deducted.⁷³ The Texas Supreme Court has even allowed the "at the well" phrase to trump an express no-deductions clause, declaring the clause surplusage as a matter of law and permitting the deduction of all post-extraction costs.⁷⁴ Therefore, all costs incurred after severance are considered post-production costs and may be deducted from a lessor's royalty.⁷⁵ Furthermore, even if a royalty clause does not contain the "at the well" phrase or similar terminology, Texas courts have implied the "at the well" phrase in oil and gas leases.⁷⁶

Jurisdictions that adhere to a version of the marketable-product rule generally find that the "at the well" phrase is insufficient to allocate post-extraction costs and hold that royalty valuation should occur at the point the product becomes marketable.⁷⁷ The basic premise upon which these jurisdictions operate is that, absent language to the contrary, the lessee is

70. See *Piney Woods Country Life Sch. v. Shell Oil Co.*, 726 F.2d 225 (5th Cir. 1984); *Martin v. Glass*, 571 F. Supp. 1406, 1415 (N.D. Tex. 1983), *aff'd*, 736 F.2d 1524 (5th Cir. 1984); *Schroeder v. Terra Energy, Ltd.*, 565 N.W.2d 887, 893 (Mich. Ct. App. 1997); *Creson v. Amoco Prod. Co.*, 10 P.3d 853 (N.M. App. 2000).

71. *Id.*

72. *Id.*; see also Poitevent, *supra* note 10, at 720.

73. *Martin*, 571 F. Supp. at 1412; see also *Heritage Res., Inc. v. NationsBank*, 939 S.W.2d 118, 121 (Tex. 1996).

74. *Heritage Res.*, 939 S.W.2d 118.

75. *Martin*, 571 F. Supp. at 1412.

76. *Id.*

77. *Rogers v. Westerman Farm Co.*, 29 P.3d 887 (Colo. 2001); *Sternberger v. Marathon Oil Co.*, 894 P.2d 788 (Kan. 1995); *Mittelstaedt v. Santa Fe Minerals, Inc.*, 1998 OK 7, 954 P.2d 1203.

responsible for all costs incurred in making a product marketable.⁷⁸ The marketable-product jurisdictions have found the “at the well” phrase insufficient to allocate post-extraction costs either because the court found the lease’s language silent with respect to the allocation of costs or because the court found the language ambiguous.⁷⁹ Additionally, in some cases, courts simply ignore the “at the well” phrase.⁸⁰ Although the “at the well” phrase has been found insufficient to allocate all post-extraction costs in all marketable-product jurisdictions, a few states may find that it sufficiently provides the location of royalty valuation.⁸¹ Thus, in these jurisdictions, when royalty is to be valued “at the well,” the lessee may be allowed to deduct reasonable transportation costs.

In marketable-product jurisdictions, once a court determines that the lease language fails to allocate post-extraction costs to a lessor, the courts have then resolved the case based upon the implied covenant to market to determine whether any post-extraction costs may be deducted from a lessor’s royalty payment.⁸² Pursuant to the implied covenant to market, the lessee is responsible for all costs incurred to make the product marketable.⁸³ Accordingly, the lessee completes her duty when a marketable product is obtained, and royalty valuation should occur at this point.⁸⁴ In addressing the issue of when a product is marketable, the jurisdictions that adhere to the marketable-product rule do not agree on the details.⁸⁵

4. Two Methods of “Deducting” Post-Extraction Costs

Once the royalty valuation point is ascertained, one of two methods is used to take into account post-valuation-point costs where the sale is downstream of the valuation point.⁸⁶ These methods are used in both at-the-well and marketable-product states.⁸⁷ The first—and traditionally preferable—method

78. See *Garman v. Conoco, Inc.* 886 P.2d 652, 661 (Colo. 1994).

79. See *Rogers*, 29 P.3d 887; *Estate of Tawney v. Columbia Natural Res., L.L.C.*, 633 S.E.2d 22 (W. Va. 2006).

80. See *Hanna Oil & Gas Co. v. Taylor*, 759 S.W.2d 563 (Ark. 1988); *Mittelstaedt*, 1998 OK 7, 954 P.2d 1203.

81. See *Sternberger*, 894 P.2d 788.

82. See *Rogers*, 29 P.3d 887; *Mittelstaedt*, 1998 OK 7, 954 P.2d 1203; *Tawney*, 633 S.E.2d 22.

83. *Rogers*, 29 P.3d 887; *Mittelstaedt*, 1998 OK 7, 954 P.2d 1203; *Tawney*, 633 S.E.2d 22.

84. See *Rogers*, 29 P.3d 887; *Mittelstaedt*, 1998 OK 7, 954 P.2d 1203; *Tawney*, 633 S.E.2d 22.

85. See *Rogers*, 29 P.3d 887; *Sternberger*, 894 P.2d 788; *Mittelstaedt*, 1998 OK 7, 954 P.2d 1203; *Tawney*, 633 S.E.2d 22.

86. Kramer, *supra* note 28, at 244-45.

87. See *Martin v. Glass*, 574 F. Supp. 1406 (N.D. Tex. 1983), *aff’d*, 736 F.2d 1524 (5th Cir.

is comparable sales.⁸⁸ Pursuant to this approach, post-extraction costs are not actually deducted from the lessor's royalty.⁸⁹ Rather, the courts look for comparable sales at the same or similar valuation point of gas of a similar quality to determine the value of the gas at issue.⁹⁰ For example, if the royalty-valuation point is at the well, comparable sales of gas at the well are used to determine the price on which royalty is paid. The comparable-sales method is frequently unworkable, however, because there often are no comparable sales at the same or similar valuation point—especially in an at-the-well jurisdiction.⁹¹

Under the second method, the work-back approach, post-valuation costs are deducted from the proceeds or value at the actual point of sale, depending on other language in the lease.⁹² For example, costs incurred to transport a product to a distant market beyond the royalty-valuation point will be deducted from either the proceeds or market value at the point of sale to determine the value on which royalty is due.

In two jurisdictions, Oklahoma and Colorado, royalty is due on the greater of the comparable sales or work-back approach.⁹³ And the lessee appears to bear the burden of this calculation.⁹⁴

Royalty valuation remains a challenge because of the various jurisdictional views regarding post-extraction costs. This is especially true in states adhering to the marketable-product rule because of disparity among these jurisdictions regarding the precise allocation of post-extraction costs.⁹⁵ This lack of uniformity hinders the interpretation of lease language, the determination of marketability, and the deduction of costs. The lack of uniformity can also result in a lessor being paid a significantly different amount for royalty depending on the state in which the property subject to the oil and gas lease is located.⁹⁶

1984).

88. *Id.*

89. *Id.*

90. *Id.*; see also Kramer, *supra* note 28, at 244.

91. *Martin*, 571 F. Supp. 1406; Kramer, *supra* note 28, at 246.

92. Kramer, *supra* note 28, at 246.

93. See *Garman v. Conoco, Inc.*, 886 P.2d 652, 661 (Colo. 1994); *Mittelstaedt v. Santa Fe Minerals, Inc.*, 1998 OK 7, ¶ 29, 954 P.2d 1203, 1210.

94. *Garman*, 886 P.2d at 661; *Mittelstaedt*, ¶ 2, 954 P.2d at 1204.

95. See *infra* Part III.

96. See *infra* Part IV.

III. Marketable-Product Jurisdictions

To examine the differences in the courts' treatment of post-extraction costs pursuant to the marketable-product approach, five states' variations of the approach, and their supporting case law, are discussed. Although some states have adopted the marketable-product rule by statute,⁹⁷ these states are not discussed because, outside of Wyoming, case law interpreting the statutes is lacking and because the focus of this article is how the courts without statutes construe royalty clauses for valuation purposes. The five states examined are Arkansas, Kansas, Colorado, West Virginia, and Oklahoma. In all five states, royalty valuation should occur when a marketable product is obtained, and the lessee is required to bear all costs incurred in obtaining a marketable product.⁹⁸ Thus, the deductibility of post-extraction costs hinges on whether a marketable product has been obtained. The five states, as exemplified by case law, have reached somewhat different conclusions as to the point at which a product becomes marketable. Additionally, the five states vary as to whether marketability is purely a question of fact or, in part, a question of law.

A. Arkansas

The rule in Arkansas is not yet firmly established; however, two cases, when taken together, suggest that Arkansas can be classified as a marketable-product jurisdiction. The two cases in which the Arkansas Supreme Court addressed the deduction of post-extraction costs are *Clear Creek Oil & Gas Co. v. Bushmiaer*,⁹⁹ and *Hanna Oil & Gas Co. v. Taylor*.¹⁰⁰ At issue in *Clear Creek* was the amount of gas royalty due under a lease that provided for royalty to be paid on the "market price of royalty gas at the well."¹⁰¹ When calculating royalty, the lessee in *Clear Creek* did not deduct specific post-extraction costs.¹⁰² Rather, the lessee paid royalty at the price other companies were paying for royalty on gas in the same field and at the wells.¹⁰³ The court held that, because there was no market for gas at the well, royalty should be

97. See MICH. COMP. LAWS ANN. § 324.61503(b) (West 1999); NEV. REV. STAT. ANN. § 522.115(b) (West 2000); WYO. STAT. ANN. § 30-5-304 (2007).

98. See *Hanna Oil & Gas Co. v. Taylor*, 759 S.W.2d 563 (Ark. 1988); *Rogers v. Westerman Farm Co.*, 29 P.3d 887 (Colo. 2001); *Sternberger v. Marathon Oil Co.*, 894 P.2d 788 (Kan. 1995); *Mittelstaedt*, 1998 OK 7, ¶ 26, 954 P.2d 1203, 1209; *Estate of Tawney v. Columbia Natural Res., L.L.C.*, 633 S.E.2d 22 (W. Va. 2006).

99. 264 S.W. 830 (Ark. 1924).

100. 759 S.W.2d 563 (Ark. 1988).

101. *Clear Creek*, 264 S.W. at 831.

102. *Id.*

103. *Id.*

determined at the “the nearest place where they have market value,” less transportation costs.¹⁰⁴ Although the *Clear Creek* court addressed the point at which royalty should be calculated, not the deduction of post-extract costs, the court’s holding indicates that deduction of post-extraction costs would not be allowed.

Six decades later, in *Hanna Oil & Gas Co. v. Taylor*, the Arkansas Supreme Court had the opportunity to address the deduction of post-extraction costs, specifically compression costs.¹⁰⁵ In *Hanna*, the Arkansas Supreme Court, without expressly stating it was doing so, applied the marketable-product rule.¹⁰⁶ At issue in *Hanna* were deductions from the lessor’s royalty payments for compression costs.¹⁰⁷ The lease royalty provision provided that royalty was to be paid on “proceeds . . . at the well”¹⁰⁸ Compression was necessary to deliver the gas at the required pressure.¹⁰⁹ The Supreme Court of Arkansas concluded that under the royalty clause providing for royalty payment based on proceeds at the well, the lessee could not deduct compression costs.¹¹⁰ The court reasoned that absent language allocating compression costs to the lessor, the term “proceeds” meant total proceeds.¹¹¹ The court also stated that the parties’ construction of the agreement supported its conclusion, and the fact that the lessee waited two years before deducting compression costs indicated the lessee’s construction was consistent with the courts.¹¹²

The gas at issue in *Hanna* required compression to meet the requirements of the purchaser.¹¹³ Accordingly, the gas was not marketable until compressed, and by disallowing the deduction of compression costs from the lessor’s royalty, the court required the lessee to bear all compression costs. Furthermore, the court stated that, if the lessee had intended to deduct compression costs, he would have included language to that effect.¹¹⁴ To reach this conclusion the court had to assume that the “at the well” phrase was insufficient to allocate the costs of compression to the lessor.¹¹⁵

104. *Id.* at 832.

105. *Hanna Oil & Gas Co. v. Taylor*, 759 S.W.2d 563 (Ark. 1988).

106. *Id.*

107. *Id.* at 564.

108. *Id.*

109. *Id.* at 564-65.

110. *Id.*

111. *Id.*

112. *Id.*

113. *Id.*

114. *Id.*

115. *Id.*

Thus, the court in *Hanna* held that, absent contract language allocating the costs of compression, the lessee owing royalty under a “proceeds at the well” royalty clause may not deduct compression costs from a lessor’s royalty payment.¹¹⁶ The court never stated that it was applying the marketable-product rule, nor did it mention the implied covenant to market; however, the court’s holding is more consistent with the marketable-product rule than it is the at-the-well rule. The court in *Hanna* effectively required the lessee to bear the costs incurred in obtaining a marketable product and also effectively found the “at the well” phrase insufficient to allocate costs.

In his dissent in *Hanna*, Justice Hays’ discussion of the implied covenant to market and the deduction of transportation costs inadvertently supports the conclusion that the court was applying the marketable-product rule.¹¹⁷ Justice Hays recognized that it could be argued that the lessee is required to bear costs incurred to compress gas under the implied covenant to market.¹¹⁸ However, he then noted that the court, in *Clear Creek*, rejected the idea that the lessee was required to bear all transportation costs.¹¹⁹ Justice Hays then equated compression costs with transportation costs, stating that they are both “post-production” costs, and that he believed the court should follow *Clear Creek*, thereby allowing the lessee to deduct compression costs from the lessor’s royalty.¹²⁰ Justice Hays’ analysis concerning the implied covenant to market, however, is flawed. Although compression and long-distance transportation are both post-extraction costs, they are not one and the same. Transportation costs to a distant market, like the costs in *Clear Creek*, are deductible from a lessor’s royalty payment under the traditional marketable-product rule.¹²¹ This is because, unlike compression costs incurred to make the product marketable, transportation costs are deductible when incurred to transport an already marketable product.¹²²

Justice Hays did point to one difference between the lease royalty clauses in *Clear Creek* and *Hanna*. While the lease provision in *Clear Creek* required royalty to be paid on “market price,” the lease provision in *Hanna* called for royalty to be paid on “proceeds.”¹²³ Justice Hays accurately stated that the difference is irrelevant because the issue in the case is not the basis for calculating the royalty (market value or proceeds), but rather it is the issue of

116. *Id.*

117. *Id.* at 565-66 (Hays, J., dissenting).

118. *Id.*

119. *Id.* at 566.

120. *Id.*

121. See KUNTZ, *supra* note 1, § 40.5; Anderson, *supra* note 67, at 598.

122. See KUNTZ, *supra* note 1, § 40.5.

123. *Hanna*, 759 S.W.2d at 564-65.

what expenses are deductible from the basis.¹²⁴ This assertion is accurate as well as consistent with the marketable-product rule. As previously discussed, royalty valuation is a two-step inquiry, the first step is to determine the amount on which royalty is to be paid (market value or proceeds), and the next is to determine what deductions may be taken. Both *Clear Creek* and *Hanna* address deductions, thus, for purposes of that inquiry, the fact that one royalty provision provides for proceeds and the other market value is irrelevant.

Thus, while Arkansas has yet to explicitly state that it requires the lessee to bear all costs incurred in obtaining a marketable product, the Arkansas Supreme Court's holdings in both *Clear Creek* and *Hanna* lend significant support to the conclusion that Arkansas is a marketable-product jurisdiction. Under Arkansas' variation of the marketable-product rule, as applied in *Clear Creek* and *Hanna*, compression costs incurred to meet the requirements of the purchaser are not deductible, but costs incurred to transport compressed marketable gas to a distant market are deductible. In both cases, however, the court failed to expressly address the "at the well" phrase present in the lease royalty clauses.

The Arkansas Supreme Court appears to have implicitly adopted the marketable-product rule by applying it without expressly saying so. It remains uncertain whether Arkansas's variation of the marketable-product rule is based on the implied covenant to market or on the contractual view that production is not complete until a marketable product is obtained. This issue will not be resolved until the court further defines the basis for the rule, as well as expressly stating that the marketable-product rule applies. Nevertheless, as previously stated, the result generally is the same under either view.

If the Arkansas courts continue to adhere to *Clear Creek* and *Hanna*, it follows that costs incurred to enhance an already marketable product would be deductible from a lessor's royalty, including transportation costs to a distant market. Furthermore, it remains unclear whether marketability, pursuant to Arkansas's rule, will be treated as a question of fact or as a mixed question of fact and law. For example, might compression be deductible if uncompressed gas is actually sold in the field in an otherwise comparable sale? Or will compression, as a matter of marketing custom and practice be deemed to be nondeductible? The court's emphasis on the need to compress the gas to meet required pressures suggests that the deductibility of compression may be a question of fact. In any event, the court seems disinclined to treat compression as a component of transportation.

124. *Id.*

B. Kansas

Kansas first adopted the marketable-product rule in *Gilmore v. Superior Oil Co.*¹²⁵ The lessee in *Gilmore* installed a compressor station to compress the gas for delivery into the purchaser's pipeline on the leased premises.¹²⁶ The lessee then deducted costs for compression from the lessor's royalty payment, and the lessor alleged these deductions were improper.¹²⁷ The lease royalty clause in *Gilmore* required royalty to be paid on "proceeds . . . at the mouth of the well . . ." ¹²⁸ The Kansas Supreme Court stated that prior to compression there was no market for the gas.¹²⁹ The purpose of the compression was "to put enough force behind the gas to enable it to enter the pipeline *on the lease*," and that this made the gas marketable.¹³⁰ The court then discussed the implied covenant to market and Professor Merrill's views about the covenant.¹³¹ The court concluded that, under the implied covenant to market, the lessee has the duty to prepare the product for market.¹³² Thus, the lessee is required to bear costs incurred in preparing the product for market because they are necessary to make the gas marketable.¹³³ Accordingly, royalty is owed on the product when it becomes marketable.¹³⁴ The court then held that the lessee was not allowed to deduct compression costs because the costs were necessary to make the gas marketable.¹³⁵

The rule in *Gilmore* was applied in *Schupbach v. Continental Oil Co.*,¹³⁶ a case with nearly identical facts. At issue in *Schupbach* were deductions for compression costs from a lessor's royalty payment.¹³⁷ The lease royalty clause called for royalty to be paid on gross "proceeds . . . at the mouth of the well."¹³⁸ The Kansas Supreme Court concluded that the court's decision in *Gilmore* was controlling.¹³⁹ Accordingly, the court held that the lessee was not entitled to deduct compression costs from the lessor's royalty payment because

125. 388 P.2d 602 (Kan. 1964).

126. *Id.*

127. *Id.* at 604.

128. *Id.*

129. *Id.* at 606.

130. *Id.*

131. *Id.* at 606-07 (citing MERRILL, *supra* note 56, § 85).

132. *Id.*

133. *Id.*

134. *Id.*

135. *Id.*

136. 394 P.2d 1 (Kan. 1964).

137. *Id.* at 2.

138. *Id.*

139. *Id.* at 5.

the costs were necessary to make the gas marketable.¹⁴⁰ The Kansas Supreme Court based its adoption of the marketable-product rule on Professor Merrill's view that the implied covenant to market obligates a lessee to prepare the product for market.

The court further defined its version of the marketable-product rule in *Sternberger v. Marathon Oil Co.*¹⁴¹ At issue in *Sternberger* were deductions from royalty and overriding royalty interests for costs labeled as "gathering line amortization expenses."¹⁴² The deductions were taken to recover a portion of the expenses the operator incurred in constructing and maintaining gas gathering systems to transport gas from the leased premises to pipeline connections off the lease.¹⁴³ The gathering system was constructed because there was no market for gas at the wellhead.¹⁴⁴ The royalty clause in *Sternberger* called for royalty to be paid on "market price at the well."¹⁴⁵

Regarding the issues of whether the deductions for gathering were appropriate, the court turned to prior Kansas case law holding that "where royalties are based on market price 'at the well' . . . the lessor must bear a proportionate share of the expenses in transporting the gas or oil to a distant market."¹⁴⁶ The court also discussed *Schupbach* and *Gilmore*.¹⁴⁷ In these cases, lessees were not allowed to deduct costs for compression, on or off the premises, because compression was necessary to make the gas marketable.¹⁴⁸ According to the court, "[t]he lessee has the duty to produce a marketable product, and the lessee alone bears the expense in making the product marketable."¹⁴⁹

Additionally, the court held that, even though the "at the well" phrase is silent as to post-extraction costs, the language is nevertheless unambiguous and provides the location point of valuation for royalty payments.¹⁵⁰ In other words, the "at the well" phrase does not address the condition of the product; however, it does specify the location at which royalty is to be calculated, and therefore transportation costs are deductible. Thus, whether the deductions from the lessors' royalties were proper depended on whether the costs were for

140. *Id.* at 5-7.

141. 894 P.2d 788 (Kan. 1995).

142. *Id.* at 792.

143. *Id.*

144. *Id.*

145. *Id.*

146. *Id.* at 796.

147. *Id.* at 798 (citing *Schupbach v. Cont'l Oil Co.*, 394 P.2d 1 (Kan. 1964); *Gilmore v. Superior Oil Co.*, 388 P.2d 602 (Kan. 1964)).

148. *Schupbach*, 394 P.2d 1; *Gilmore*, 388 P.2d 602.

149. *Sternberger*, 894 P.2d at 799.

150. *Id.* at 794-95.

transportation, or whether the costs were incurred in making the product marketable and must be borne by the lessee alone.

The *Sternberger* court then determined that, other than the lack of a purchaser at the well, there was no evidence that the gas produced was not otherwise marketable at the well.¹⁵¹ The court also determined that there was no evidence that any costs to condition the gas for marketing, such as compression, processing, or dehydration, had been incurred or deducted.¹⁵² The court found that although the gas was marketable at the well, there was no market at the well, and that the pipeline was constructed to transport the gas to a distant market.¹⁵³ Accordingly, the court held that the deductions were for transportation,¹⁵⁴ and that the costs incurred to transport the marketable gas to the point of sale were properly deducted from the lessors' royalty.¹⁵⁵

Thus, under Kansas law, the "at the well" phrase and similar terminology provide the location at which the royalty is to be valued, but the lessee still has a duty to obtain a marketable product and bear all costs incurred in conditioning the gas for that purpose.¹⁵⁶ Therefore, under a "market price at the well" royalty clause, once a product is in a marketable condition and if there is a market in the vicinity of the field,¹⁵⁷ the lessor is entitled to the product's market price in the field even if the product is sold further downstream.¹⁵⁸ If there is no market available at the well, however, the lessee may deduct costs incurred to transport the marketable product from the well to the point of sale provided the lessee proves that the costs were reasonable.¹⁵⁹ Thus, royalty would be determined on the market price at the point of sale by deducting the reasonable cost of transportation from the wellhead to the point of sale (the work-back method).

If the royalty clause calls for payment of royalty on "proceeds at the well," the lessee may not deduct any costs incurred in obtaining a marketable product.¹⁶⁰ The same analysis as "market value" clauses applies to "proceeds" clauses regarding transportation costs.¹⁶¹ Further, under either a "proceeds" or "market value" lease, once a marketable product is obtained, costs incurred

151. *Id.*

152. *Id.*

153. *Id.*

154. *Id.*

155. *Id.*

156. *Id.* at 801.

157. *See id.* at 795.

158. *Id.* at 795, 801.

159. *Id.* at 801.

160. *Id.* at 798-800.

161. *Id.*

to enhance the value of the marketable product may be deducted from a lessor's royalty payment if the lessee proves the costs were reasonable.¹⁶²

Pursuant to Kansas' version of the marketable-product rule, a marketable product is obtained when the product is in a marketable condition. In other words, marketability depends on conditioning not on location. Perhaps inadvertently, the court seems to have reached the decision that gas is in a marketable condition as a matter of law rather than as a matter of fact. This is evidenced by the court's holding in *Sternberger*. The court in *Sternberger* indicated that the product was in a marketable condition at the well, but because there was no market at the well it had to be transported to a distant market.¹⁶³ Accordingly, the lessee was allowed to deduct transportation costs so that royalty reflected the value of the product when it became marketable rather than after its value was enhanced because of transportation to a distant market.¹⁶⁴ The court comes to this conclusion after distinguishing *Sternberger* from prior cases in which deductions for compression were disallowed because compression is a marketing cost, and stating that there was evidence that the gas was not marketable at the well.¹⁶⁵ Thus, the Kansas rule seems to treat marketability as a question of law by disallowing the deduction of compression as a matter of law, but allowing the deduction of other gathering costs. In other words, rather than treat the deductibility of all post-extraction costs as a factual inquiry into whether a marketable product has been obtained, the Kansas rule seems to view compression as always necessary in obtaining a marketable product and is thus not deductible.¹⁶⁶ Therefore, while transportation costs, including gathering, may be deductible, costs for compression to move gas away from the well, which are arguably part of transportation, are nevertheless not deductible as a matter of law.¹⁶⁷ It is possible, however, that compression costs incurred downstream of the lease to move gas to a distant market could be considered transportation cost, and as such would be deductible.

C. Colorado

The Colorado Supreme Court first applied the marketable-product rule in *Garman v. Conoco, Inc.*¹⁶⁸ The court addressed the issue of whether a lessee is allowed to deduct post-extraction expenses from an overriding royalty

162. *Id.* at 800.

163. *Id.*

164. *Id.*

165. *Id.*

166. *Id.*

167. *Id.*

168. 886 P.2d 652 (Colo. 1994).

interest.¹⁶⁹ The defendant deducted certain post-extraction expenses, including processing, transportation, and compression costs, from the plaintiff's overriding royalty.¹⁷⁰ The plaintiffs argued that post-extraction charges should not have been deducted because post-extraction costs incurred in making the gas marketable were the sole responsibility of the lessee.¹⁷¹ In contrast, the defendant argued that all post-extraction costs incurred after severance at the well should be allocated proportionately between royalty, overriding royalty, and working interest owners because all expenses after severance improve or enhance the value of the gas.¹⁷²

In addressing the deductibility of post-extraction costs, the court first concluded that the assignment creating the overriding royalty was silent regarding the allocation of post-extraction costs.¹⁷³ The court came to this conclusion without considering the language of the assignment.¹⁷⁴ The court then stated that, regarding the allocation of post-extraction expenses, two lines of cases had developed based on "when production is established and a royalty interest accrues."¹⁷⁵ One line of cases, stemming from Texas and Louisiana, follow the rule that nonoperating interests (royalty and overriding royalty owners) must bear their proportionate share of costs that are incurred after gas is severed at the wellhead.¹⁷⁶ The second line of cases, stemming from Kansas and Oklahoma, follow a contrary rule based on an operator's implied covenant to market gas.¹⁷⁷ Additionally, the court noted that Arkansas and North Dakota "have reached similar conclusions when considering lease royalty clauses which are silent as to allocation of post-production costs."¹⁷⁸

169. *Id.* at 653. "An overriding royalty is a percentage of the gross production payable to some person other than the lessor or persons claiming under the lessor, and arises where an owner of the working interest contracts to deliver a part of the gross production to another person . . ." 38 AM. JUR. 2D *Gas and Oil* § 215 (1999).

170. *Garman*, 886 P.2d at 653.

171. *Id.* at 655-59.

172. *Id.* at 655-56.

173. *Id.* at 654.

174. *Id.*

175. *Id.* at 657.

176. *Id.* at 657-68 (citing *Martin v. Glass*, 571 F. Supp. 1406, 1415 (N.D. Tex. 1983) (applying Texas law), *aff'd*, 736 F.2d 1524 (5th Cir. 1984); *Merritt v. Sw. Elec. Power Co.*, 499 So. 2d 210 (La. Ct. App. 1986); *Dancinger Oil & Refineries v. Hamill Drilling Co.*, 171 S.W.2d 321 (Tex. 1943)).

177. *Id.* at 659 (citing *Gilmore v. Superior Oil Co.*, 388 P.2d 602, 606 (Kan. 1964); *Wood v. TXO Prod. Corp.*, 1992 OK 100, ¶ 9, 854 P.2d 880, 882).

178. *Id.* at 658 (citing *Hanna Oil & Gas Co. v. Taylor*, 759 S.W.2d 563, 565 (Ark. 1988); *West v. Alpar Res., Inc.*, 298 N.W.2d 484, 491 (N.D. 1980)).

After discussing other jurisdictions' approaches to the allocation of post-extraction costs, the court examined the implied duty to market.¹⁷⁹ The court stated that "the implied covenant to market obligates the lessee to incur those post-production costs necessary to place gas in a condition acceptable for market" and that "[o]verriding royalty interest owners are not obligated to share in these costs."¹⁸⁰ Moreover, the court stated:

Upon obtaining a marketable product, any additional costs incurred to enhance the value of the *marketable* gas, such as those costs conceded by the [plaintiffs], may be charged against nonworking interests. To the extent that certain processing costs enhance the value of an already marketable product the burden should be placed upon the lessee to show such costs are reasonable, and that actual royalty revenues increase in proportion with the costs assessed against the nonworking interest. . . .

For the above reasons[,] . . . absent an assignment provision to the contrary, overriding royalty interest owners are not obligated to bear any share of post-production expenses, such as compressing, transporting and processing, undertaken to transform raw gas produced at the surface into a marketable product.¹⁸¹

Thus, the *Garman* court held that where the language in the lease is silent, the implied covenant to market obligates the lessee to pay all post-extraction costs incurred transforming the gas into a marketable form.¹⁸² Additionally, if a lessee argues that costs were incurred to enhance the value of already marketable gas, the lessee has the burden of proving the reasonableness of the costs and that net royalty revenues were increased.¹⁸³ Applying the Colorado Supreme Court's analysis in *Garman*, royalty valuation occurs at the point the product becomes marketable. Accordingly, the point of marketability is significant in determining whether post-extraction costs can be allocated to lessors.

In *Rogers v. Westerman*, the Colorado Supreme Court felt the need to define the term "marketable product."¹⁸⁴ In *Rogers*, the court addressed the sufficiency of the "at the well" phrase in allocating costs, the implied covenant to market, and the definition of marketability.¹⁸⁵ The lessors brought suit

179. *Id.* at 658-60.

180. *Id.* at 659.

181. *Id.* at 661 (footnote omitted).

182. *Id.* at 659.

183. *Id.* at 661.

184. *Rogers v. Westerman*, 29 P.3d 887 (Colo. 2001).

185. *Id.* at 891, 896.

alleging royalty underpayment because of deductions from the lessors' royalty for gathering, dehydration, and compression.¹⁸⁶ There were four types of leases at issue and the leases provided for royalty to be paid on either the "market value" or the "proceeds" from the sale of gas "at the well" or "at the mouth of the well."¹⁸⁷ The court stated that the gas at the wells was sold "sweet and dry" as it emerged from the well.¹⁸⁸ The gas that was sold away from the wells was first gathered to move the gas to the main line and then compressed and dehydrated to meet the interstate pipeline specifications.¹⁸⁹ Royalties for gas sold away from the wells were based on the price of the gas sold with deductions for the costs of gathering, compression, and dehydration.¹⁹⁰

The Colorado Supreme Court began its analysis by addressing the "at the well" and "at the mouth of the well" phrases in the lease royalty clauses.¹⁹¹ The court found that the "at the well" phrases in the four types of leases in dispute in *Rogers* were subject to more than one interpretation.¹⁹² Nevertheless, the court stated that these phrases were silent as to the allocation of post-extraction costs because they failed to adequately describe the calculation and allocation of cost between the parties.¹⁹³ The court stated that contract language should be construed as a whole and specific phrases should not be interpreted in isolation.¹⁹⁴ The court, however, disregarded its own rule of construction by stating that "this language in isolation is actually silent with respect to those costs."¹⁹⁵ The court continued to contradict its own rule by viewing the rest of the lease language in isolation, and concluding that no light is shed on how, or whether, the allocation of costs was intended to be addressed by this phrase.¹⁹⁶

The court also discussed other courts' interpretations of "at the well" terminology, criticizing both courts that have held that the "at the well" phrase speaks to both quality and location, as well as courts that have held that the "at the well" phrase speaks only to the location for royalty valuation.¹⁹⁷ The court also emphasized the rule that "oil and gas leases are strictly construed against

186. *Id.* at 891.

187. *Id.*

188. *Id.* at 892.

189. *Id.*

190. *Id.* at 893-94.

191. *Id.* at 896.

192. *Id.* at 896-97.

193. *Id.* at 894-96.

194. *Id.*

195. *Id.* at 898.

196. *Id.*

197. *Id.* at 898-902.

the lessee in favor of the lessor.”¹⁹⁸ Thus, the court held that “at the well” terminology is silent and speaks to neither quality nor location.¹⁹⁹ Next, the court stated that because the lease language was silent regarding the allocation of costs, the implied covenant to market controls the determination of whether the deductions were improper.²⁰⁰

The *Rogers* court began its discussion of the implied covenant to market by examining its prior holding in *Garman* that “the implied covenant to market obligates the lessee to incur those post-production costs necessary to place gas in a condition acceptable for market.”²⁰¹ The court stated that this covenant relieves royalty owners from responsibility for any costs incurred to obtain a marketable product.²⁰² In other words, the deduction of post-extraction costs also depends on the location where the product becomes marketable, and the lessee must bear all costs incurred to that point. Additionally, costs incurred after obtaining a marketable product that enhance the value of the product, or relate to the product’s transportation to another location, may be allocated between the lessee and lessor if certain conditions are met.²⁰³

The court in *Rogers* stated that its ruling in *Garman* was limited because, although it held that all costs incurred in placing gas in a marketable product were to be borne by the lessee alone, it failed to define marketable product.²⁰⁴ The court then defined a marketable product stating that “marketability” includes “both a reference to the physical condition of the gas, as well as the ability for the gas to be sold in a commercial marketplace.”²⁰⁵ To guide its definition of marketable product, the court examined the marketable-product rule but declined to adopt the rule in its entirety.²⁰⁶ The marketable-rule provides, “the point where a marketable product is first obtained is the logical point where the exploration and production segment of the oil and gas industry ends, is the point where the primary objective of the lease contract is achieved, and therefore is the logical point for the calculation of royalty.”²⁰⁷ Thus, the point at which a first-marketable product is obtained is the point at which royalty calculations should be made.²⁰⁸ The marketable-product rule, however,

198. *Id.* at 901.

199. *Id.* at 902-03.

200. *Id.* at 902.

201. *Id.* (quoting *Garman v. Conoco, Inc.*, 886 P.2d 652, 659 (Colo. 1994)).

202. *Id.* (citing *Garman*, 886 P.2d at 659).

203. *Id.*

204. *Id.* at 896.

205. *Id.* at 903.

206. *Id.* at 904.

207. *Id.* (quoting *Anderson*, *supra* note 2, at 637).

208. *Id.*

does not place the extra burden on the lessee of requiring him to bear all costs incurred in transporting the marketable product to a market location.²⁰⁹

After refusing to adopt the marketable-product rule in its entirety, the *Rogers* court greatly extended the lessees' duty under its version of the implied covenant to market when it held:

Gas is marketable when it is in the physical condition such that it is acceptable to bought and sold in a commercial marketplace, and in the location of a commercial marketplace, such that it is commercially saleable in the oil and gas marketplace. The determination of whether gas is marketable is a question of fact, to be resolved by a fact finder.²¹⁰

Accordingly, gas may be found to reach first-marketable product status either upon its severance from the wellhead, if the gas is in a marketable condition at the wellhead and if a commercial market for the product exists at the wellhead, or upon its suitability and entry into a market pipeline. Thus, in Colorado, pursuant to the implied covenant to market, the lessee must bear all expenses incurred to obtain a "marketable product," with the definition of "marketable" including both a marketable-condition requirement and a market-location requirement.²¹¹ Consequently, according to the Colorado Supreme Court's definition of marketable product, all costs incurred to transport gas to a market location are to be borne solely by the lessee.²¹²

The court greatly extended the lessee's duty to market by requiring that the lessee bear all costs incurred in transporting a product to a market location. Although the transportation charges at issue in *Rogers* were for gathering, the court did not limit the rule to gathering costs. The lack of a limitation on transportation costs implies that costs incurred to transport gas to a distant marketplace would be the responsibility of the lessee alone if its first market was at a distant location. After the product becomes marketable and is at a market location, additional costs to improve or transport the product are allocated proportionately between the lessee and the lessor as long as they are reasonable. These costs, however, are proportionately allocated only if they are incurred after the product is both in a marketable condition and at a market location and if the value downstream benefits the royalty owner.

The Colorado Court of Appeals applied the *Rogers* holding in *Savage v. Williams Production RMT Co.*²¹³ In *Savage*, a mineral owner sued a lessee to

209. See Anderson, *supra* note 2, at 640.

210. *Rogers*, 29 P.3d at 906.

211. *Id.* at 904.

212. *Id.* at 906.

213. 140 P.3d 67 (Colo. Ct. App. 2005).

recover unpaid royalties allegedly resulting from improper deduction of costs incurred in gathering, processing, and transporting gas.²¹⁴ The Colorado Court of Appeals upheld the trial court's decision that deductions for processing costs and transportation from the mineral owner's royalty were improper.²¹⁵ The appellate court reached this conclusion after finding that the royalty clause language that provided for royalty to be paid on "one-eighth of the proceeds" was silent as to the allocation of costs.²¹⁶ The court did not state what costs were included in the term processing costs. Courts are often vague when using the term, and even though processing is the extraction of NGLs, courts often use the term when referring to treating, dehydration, and compression.²¹⁷ Thus, it remains unclear what these costs were actually for.

In *Savage*, the court compared the royalty-clause language in the lease at issue to the language of one of the leases in *Rogers*. The court concluded that the lease language did not describe where the royalties were to be calculated or address the allocation of costs between the parties.²¹⁸ After concluding that the leases were silent with respect to the allocation of costs, the court upheld the trial court's application of the marketability analysis.²¹⁹ The *Savage* court stated that the *Rogers* court determined that marketability analysis applies "[a]bsent express lease provisions addressing [the] allocation of costs."²²⁰ The court stated that, when determining whether gas is marketable, two factors—condition and location—must be considered.²²¹ The court then stated that marketable condition depends on "whether it is in the physical condition where it is acceptable to be bought and sold in a commercial marketplace,"²²² and that market location means a "commercial marketplace" defined as "the region in which any commodity or product can be sold; the geographical or economic extent of the commercial demand."²²³

The court of appeals then examined the trial court's application of the marketability analysis.²²⁴ The trial court had determined that, because the gas had to be processed and transported to the pipeline before it could be sold, it was not marketable at the wellhead.²²⁵ The lessee had contended that this was

214. *Id.* at 69.

215. *Id.*

216. *Id.*

217. *See supra* note 35 and accompanying text.

218. *Savage*, 140 P.3d at 70.

219. *Id.* (quoting *Rogers v. Westerman Farm Co.*, 29 P.3d 887, 906 (Colo. 2001)).

220. *Id.* (quoting *Rogers*, 29 P.3d at 906) (alterations in original).

221. *Id.*

222. *Id.* (quoting *Rogers*, 29 P.3d at 905) (internal quotation marks omitted).

223. *Id.* (quoting *Rogers*, 29 P.3d at 905).

224. *Id.* at 71.

225. *Id.*

an erroneous conclusion because a company had offered to purchase gas produced at the wellhead in 1984, and therefore, it was marketable at the well.²²⁶ The appellate court, however, upheld the trial court's statement that the gas was not marketable, recognizing that "[g]as is not marketable merely because it is sold."²²⁷ Furthermore, the appellate court stated that although a "single purchaser . . . is evidence that there is a market for the gas," a single purchaser does not conclusively establish a market.²²⁸ Thus, the offer to purchase the gas at the wellhead provided one consideration in determining whether a commercial market for the gas existed.²²⁹ Additionally, the court stated that the determination of marketability is a question of fact and will not be disturbed unless clearly erroneous.²³⁰ The appellate court stated that "there was sufficient evidence in the record from which the trial court could have determined that there was almost no commercial market for the gas"²³¹ After examining the marketability analysis, the court of appeals upheld the trial court's conclusion that the gas was marketable only after processing and transportation to the interstate pipeline.²³²

Ultimately, *Savage* exemplifies application of the rule articulated in *Rogers*. In *Savage*, the court continued to find lease language silent with respect to the allocation of costs, and applied the *Rogers* definition of "marketability," requiring that the product be both in a marketable condition and at a market location. Thus, under the Colorado rule, royalty valuation occurs at the point at which a marketable product is obtained and is at a market location. Furthermore, the "at the well" phrase, and similar terminology, is insufficient to allocate post-extraction costs and does not provide the location for royalty valuation. Accordingly, all costs incurred in creating a product in marketable condition and transporting that product to a market location are to be borne by the lessee alone and may not be deducted from a lessor's royalty or an overriding royalty. As stated in *Rogers*, Colorado treats all post-extraction costs, including transportation, in the same manner,²³³ whereas Kansas,²³⁴ Oklahoma,²³⁵ and perhaps Arkansas²³⁶ differentiate between transportation costs and other costs such as dehydration and compression.

226. *Id.*

227. *Id.* (quoting *Rogers*, 29 P.3d at 910) (alteration in original).

228. *Id.* (quoting *Rogers*, 29 P.3d at 910) (omission in original).

229. *Id.*

230. *Id.*

231. *Id.* at 72.

232. *Id.*

233. *See generally Rogers*, 29 P.3d 887.

234. *See supra* Part III.B.

235. *See infra* Part III.E.

236. *See supra* Part III.A.

This extension of the marketable-product rule places a large burden on the lessee by requiring the lessee to bear all costs incurred in transporting the product to a market location. The lessee is potentially responsible for substantial costs if the product must be transported to an initial distant market. As stated in both *Rogers* and *Savage*, however, once a product is marketable, any costs incurred to further enhance the product are shared by the lessor and lessee if such costs are reasonable and if the net result benefits the lessor.²³⁷ Therefore, if the lessee decides to carry an already marketable product further downstream to enhance its value, then the lessee may deduct these costs from the lessor's royalty subject to the limitation just stated. Additionally, under the Colorado rule, the determination of marketability is a question of fact.²³⁸

D. West Virginia

Thus far, three states' variations of the marketable-product rule have been examined, and with each, the lessee's duty to market the product and the costs the lessee is required to bear have increased. This trend continues in the discussion of West Virginia's approach to the allocation of post-extraction costs. West Virginia appears to prohibit any deductions of post-extraction costs and requires lessees to bear all costs incurred until the point of sale.

Just four days after the *Rogers* decision, the West Virginia Supreme Court addressed the deduction of post-extraction costs in *Wellman v. Energy Resources, Inc.*²³⁹ The leases at issue contained provisions requiring the royalty payment for gas to be based on "proceeds . . . at the mouth of the well . . ." ²⁴⁰ The lessees paid royalties after deducting certain expenses, which were unidentified by the court.²⁴¹ These deductions resulted in the payment of royalties on the basis of \$0.87 per thousand cubic feet, rather than the proceeds received by the lessees of \$2.22 per thousand cubic feet.²⁴² The lessor's brought suit alleging that royalties were improperly paid because of the deduction of these expenses.²⁴³

In examining the appropriateness of the royalty payments, the court stated that "there has been an attempt on the part of oil and gas producers in recent years to charge the landowner with a *pro rata* share of various expenses . . . such as the expense of transporting oil and gas to a point of sale, and the expense of treating or altering the oil and gas so as to put it in a marketable

237. *Rogers*, 29 P.3d at 906; *Savage*, 140 P.3d at 69.

238. *Rogers*, 29 P.3d at 905.

239. 557 S.E.2d 254 (W. Va. 2001).

240. *Id.* at 258.

241. *Id.*

242. *Id.*

243. *Id.*

condition.”²⁴⁴ The court continued this discussion, stating that the expenses have been referred to as “post-production” expenses “to escape the rule that the lessee must pay the costs of discovery and production.”²⁴⁵ The court then stated that although some states have taken this approach, others have rejected it when the lease calls for royalties to be based on proceeds under the rationale of the duty to market.²⁴⁶

After examining the case law in Colorado, Kansas, and Oklahoma, the court stated that West Virginia also recognizes the implied covenant to market and the lessee’s duty to bear all costs incurred to fulfill this duty.²⁴⁷ Accordingly, the court held that the “lessee should bear the costs associated with marketing products produced under a lease.”²⁴⁸ Marketing the product includes bearing those costs necessary to prepare the product for market. Additionally, the court stated that “if an oil and gas lease provides for a royalty based on proceeds received by the lessee, unless the lease provides otherwise, the lessee must bear all costs incurred in exploring for, producing, marketing, and transporting the product to the point of sale”²⁴⁹ The lessee may only deduct post-extraction costs if the lease provides that “the lessor shall bear some part of the costs incurred between the wellhead and the point of sale”²⁵⁰ The lessee must also prove “by evidence of the type normally developed in legal proceedings requiring an accounting, that he, the lessee, actually incurred such costs and that they were reasonable.”²⁵¹ The court stated that the “proceeds” and “at the mouth of the well” language indicated the parties intended for the lessors to bear part of the transportation costs.²⁵² Nonetheless, the court held that because there was no evidence that the costs were actually incurred or reasonable, the trial court’s award of damages was proper.²⁵³

The court in *Wellman*, like the court in *Rogers*, greatly expanded the covenant to market by increasing the lessee’s duty to bear costs. The court in *Wellman*, however, did not state that the “at the well” phrase was silent. Instead, the *Wellman* court indicated that transportation costs could be deducted if there was evidence that the lessee actually incurred the costs and

244. *Id.* at 264.

245. *Id.*

246. *Id.*

247. *Id.* at 265.

248. *Id.*

249. *Id.*

250. *Id.*

251. *Id.*

252. *Id.*

253. *Id.*

if they were reasonable. The West Virginia Supreme Court, however, dispelled the notion that transportation costs could be deducted in *Estate of Tawney v. Columbia Natural Resources, L.L.C.*²⁵⁴

In *Tawney*, the West Virginia Supreme Court further expanded the lessee's duty pursuant to the implied covenant to market.²⁵⁵ In *Tawney*, lessors filed a class-action lawsuit alleging insufficient royalty payments against a lessee.²⁵⁶ The lessee had deducted from the lessors' royalty interest "post-production costs," including the "delivery of gas from the well to the Columbia Gas Transmission ('TCO') point of delivery, processing of the gas to make it satisfactory for delivery into TCO's transportation line, and losses of volume of gas due to leaks in the gathering system or other volume loss"²⁵⁷ The court framed the issue presented in *Tawney* as "whether the 'at the wellhead'-type language at issue is sufficient to alter [the court's] generally recognized rule that the lessee must bear all costs of marketing and transporting the product to the point of sale."²⁵⁸

The leases in dispute in *Tawney* contained language in the royalty clauses indicating that the royalty payment was to be calculated in one of four ways: "at the well," "at the wellhead," "net all costs beyond the wellhead," or "less all taxes, assessments, and adjustments."²⁵⁹ In interpreting this language, the West Virginia Supreme Court examined the two predominate methods for allocating post-extraction costs, but the court explicitly rejected both approaches.²⁶⁰ Instead, the court examined West Virginia's settled law and stated that, in West Virginia, a landowner has traditionally received royalty payments "based on the sale price of the gas received by the lessee."²⁶¹

Next, the West Virginia Supreme Court found all the "at the well" phrases in the leases' royalty clauses insufficient to allocate post-extraction costs because of their ambiguity.²⁶² The court defined ambiguity as "language reasonably susceptible of two different meanings or language of such doubtful meaning that reasonable minds might be uncertain or disagree as to its meaning."²⁶³ Applying this definition, the court held that the "at the well" terminology was ambiguous because it lacked definiteness by failing to

254. 633 S.E.2d 22 (W. Va. 2006).

255. *Id.*

256. *Id.* at 25.

257. *Id.*

258. *Id.* at 28.

259. *Id.* at 25.

260. *Id.* at 27.

261. *Id.*

262. *Id.*

263. *Id.* at 28 (quoting *Payne v. Weston*, 466 S.E.2d 161, 166 (1995)) (internal quotation marks omitted).

indicate how or by what method the royalty is to be calculated or the gas valued.²⁶⁴ Further, the court stated that general language is inadequate to indicate the parties' intent to implement a rule contrary to West Virginia's traditional rule that lessors receive royalty payments based on the sale price of the gas without deductions for transporting and processing the gas.²⁶⁵ The court also rejected the lessee's argument that "when read with accompanying language such as 'gross proceeds,' 'market price,' and 'net of all costs,' the wellhead-type language clearly calls for allocation of post-production expenses."²⁶⁶ The court stated that the phrase "gross proceeds at the wellhead" could create an inherent conflict because gas is usually not sold at the wellhead and therefore the lessee usually does not receive proceeds at the wellhead.²⁶⁷ Additionally, "market price at the wellhead" is "unclear since it contemplates the actual sale of gas at the physical location of the wellhead, although the gas generally is not sold at the wellhead."²⁶⁸ Thus, the court concluded that these phrases were ambiguous regarding the allocation of post-extraction costs.

After concluding that the four variations of the "at the wellhead" phrase in the leases were ambiguous, the court then construed the language against the lessee.²⁶⁹ The court stated that if the lessee intended "the lessors to bear a portion of the transportation and processing costs of oil and gas, [the lessee] could have written into the leases specific language which clearly informed the lessors exactly how their royalties were to be calculated and what deductions were to be taken from the royalty amounts"²⁷⁰ Accordingly, the court held that

language in an oil and gas lease that is intended to allocate between the lessor and lessee the costs of marketing the product and transporting it to the point of sale must expressly provide that the lessor shall bear some part of the costs incurred between the wellhead and the point of sale, identify with particularity the specific deductions the lessee intends to take from the lessor's royalty . . . and indicate the method of calculating the amount to be deducted from the royalty for such post-production costs.²⁷¹

264. *Id.*

265. *Id.*

266. *Id.* at 28-29.

267. *Id.*

268. *Id.* at 29.

269. *Id.* (quoting *Charlton v. Chevrolet Motor Co.*, 174 S.E. 570 (W. Va. 1934)).

270. *Id.* at 29-30.

271. *Id.* at 30.

Furthermore, the “at the well” phrase in a lease royalty clause is ambiguous, and it “is not effective to permit the lessee to deduct from the lessor’s one-eighth royalty any portion of the costs incurred between the wellhead and the point of sale.”²⁷² Thus, the court dispelled any previous notion under *Wellman* that transportation costs could be deducted under a “proceeds at the well” type lease.

Therefore, under the court’s decision in *Tawney*, all costs incurred up to the point of sale must be borne by the lessee alone. Additionally, the “at the well” phrase is ambiguous and, thus, insufficient to allocate post-extraction costs to a lessor’s royalty payment. While the holding in *Wellman* was limited to a “proceeds at the well” lease, the *Tawney* court’s conclusion that “market price at the wellhead” is ambiguous regarding the allocation of post-extraction costs indicates that the *Tawney* rule also applies to “market price” or “market value” leases.²⁷³ The court failed to recognize that a product could be in a marketable condition prior to the point of sale and extended no exceptions for transportation costs or costs incurred to enhance an already marketable product. Rather, the court simply found that all costs are to be borne by the lessee up to the point of sale unless the lease language provides otherwise. Thus, in West Virginia, like Colorado, the “at the well” phrase provides neither the condition nor the location of royalty valuation.

This extension of the implied covenant to market seemingly surpasses Colorado’s extension of the covenant in *Rogers*. Under *Rogers*, once a product is marketable, the court allowed the deduction of additional costs incurred to improve or transport the product as long as they were reasonable.²⁷⁴ In contrast, the rule announced in *Tawney* makes no such exceptions for costs incurred after a product is marketable. Rather, *Tawney* seems to equate marketability with the point of sale. Accordingly, the West Virginia rule requires royalty valuation to occur at the point at which a marketable product is obtained, however, a marketable product is not obtained under the rule until it is sold.²⁷⁵ Thus, royalty is owed on value added to the product by transportation and any other enhancements to the product, even if the product was marketable at a point before it was sold.

The West Virginia Supreme Court based its rule on the implied covenant to market; however, the court’s indication that production is not complete until a marketable product is obtained is indicative of the contractual view advocated for by the late Professor Kuntz. Thus, the court seemingly

272. *Id.*

273. *Id.*

274. *Rogers v. Westerman Farm Co.*, 29 P.3d 887, 906 (Colo. 2001).

275. *Tawney*, 633 S.E.2d at 29.

combined the implied covenant basis and the contractual basis for the marketable-product rule. The Colorado Supreme Court, in *Rogers*, also cited Kuntz's contractual view yet found that a lessee is required to obtain a marketable product pursuant to the implied covenant.²⁷⁶ Regardless of the basis for the rule, the West Virginia Supreme Court held that the lessee is required to obtain a marketable product and equated a marketable product with the point of sale. Furthermore, marketability in West Virginia appears to be a rule of law that is based upon the fact of sale—presumably a sale at arms length, and no inquiry is made into the condition of the product at or prior to the point of sale.

E. Oklahoma's Treatment of Post-extraction Costs

After examining Arkansas, Kansas, Colorado, and West Virginia's rules regarding "at the well" terminology and the allocation of post-extraction costs, the question remains as to where the Oklahoma rule lies. The answer is probably somewhere between Kansas and Colorado. For now, Arkansas, Kansas, Oklahoma, Colorado, and West Virginia represent the order in which a lessee's duty to bear costs increases; however, Arkansas case law is rather thin. Arkansas could move further along this continuum in the future. Like all of the other states' variation of the marketable-product rule, the Oklahoma rule requires the lessee to bear all costs incurred to obtain a marketable product.²⁷⁷ The Oklahoma rule, however, differs from the other rules in its treatment of the "at the well" phrase and post-extraction costs incurred to enhance an already marketable product.

1. Oklahoma Case Law

Unlike Arkansas and Kansas, Oklahoma has an extensive history of case law in which it has applied the marketable-product rule. *Johnson v. Jernigan* was one of the earliest decisions in which the Oklahoma Supreme Court addressed the deductibility of post-extraction costs.²⁷⁸ At issue in *Johnson* were deductions from a lessor's royalty payment for transportation costs incurred to transport gas to the nearest market.²⁷⁹ The royalty clause in the lease called for royalty to be paid on the "gross proceeds at the prevailing market rate."²⁸⁰ The Oklahoma Supreme Court stated that

276. *Rogers*, 29 P.3d at 903.

277. *Mittelstaedt v. Santa Fe Minerals, Inc.*, 1998 OK 7, ¶¶ 20-22, 954 P.2d 1203, 1208 (quoting *TXO Prod. Corp. v. State ex rel. Comm'rs of the Land Office*, 1994 OK 131, ¶ 17, 903 P.2d 258, 263).

278. *Johnson v. Jernigan*, 1970 OK 180, 475 P.2d 396.

279. *Id.* ¶ 1, 475 P.2d at 397.

280. *Id.* ¶ 4, 475 P.2d at 398.

[m]arket rate means the rate at which the gas is commonly sold in the vicinity of the well. It is the market rate at the wellhead or in the field that determines the sale price, and not the market rate at the purchaser's location which may be some distance away from the lease premises.²⁸¹

Thus, the court held that the lessee's deductions from the lessor's royalty for a proportionate share of transportation costs were appropriate because no market for the gas existed at the leased premises.²⁸² The court stated that the lessee's duty to market did not include a duty to bear the full burden of delivering the product to an off-site purchaser.²⁸³ Additionally, the court distinguished *Johnson* from the prior case of *Clark v. Slick Oil Co.*,²⁸⁴ in which deductions were not allowed. *Clark* was the first case in which the court applied the marketable-product rule.²⁸⁵ The court distinguished *Johnson* from *Clark* by stating that the deductions at issue in *Clark* were for costs incurred in preparing and caring for the oil, and not the costs of transporting the oil away from the leased premises.²⁸⁶

Although the Oklahoma Supreme Court allowed for transportation costs to be deducted from a lessor's royalty in *Johnson*, the court disallowed the deduction of compression costs in *Wood v. TXO Production Corp.*²⁸⁷ The court came to this conclusion after finding that compression costs were necessary to obtain a marketable product.²⁸⁸

At issue in *Wood* were deductions from the lessor's royalty for costs incurred to compress the gas to the required pressure for entry into the purchaser's pipelines on the leased premises.²⁸⁹ The lease royalty clause provided that royalty would be paid on "the market price at the well"²⁹⁰ The court stated that, absent an agreement that the lessor and lessee would share costs of compression, the lessee could not deduct the cost of compression from the lessor's royalty payment.²⁹¹ This statement, when combined with the failure of the court to address the "at the well" phrase in the royalty clause, supports the conclusion that the "at the well" phrase was

281. *Id.* ¶ 5, 475 P.2d at 398.

282. *Id.* ¶¶ 14-15, 475 P.2d at 399.

283. *Id.*

284. 1922 OK 137, 211 P. 496.

285. *Id.*

286. *Johnson*, ¶ 17, 475 P.2d at 400.

287. 1992 OK 100, 854 P.2d 880.

288. *Id.* ¶ 9, 854 P.2d at 882.

289. *Id.* ¶ 2, 854 P.2d at 880-81.

290. *Id.* ¶ 1, 854 P.2d at 880.

291. *Id.* ¶ 11, 854 P.2d at 882-83.

insufficient to allocate costs. Furthermore, the court stated that “in Oklahoma the lessee’s duty to market involves obtaining a marketable product,” and this duty includes bearing the costs, such as compression costs, of preparing the gas for market.²⁹²

The court addressed the lessee’s argument that the compression in this case was equivalent to transportation because the compression was only “pushing” the gas into the purchaser’s pipeline and was not compression to extract the gas from the wellhead.²⁹³ The court rejected the lessee’s contention, and stated: “We have not yet held that the lessor is required to bear *any* costs of transportation where the point of sale is on the leased premises.”²⁹⁴ The court stated that, unlike *Johnson*, there was no sale at a distant market and thus no need to transport the product to the place of sale.²⁹⁵ The court, however, did not conclusively state whether compression costs could ever be considered transportation costs.

In *TXO Production Corp. v. State ex rel. Commissioners of the Land Office*,²⁹⁶ the Oklahoma Supreme Court addressed the deduction of compression, dehydration, and gathering costs from a lessor’s royalty.²⁹⁷ The royalty clause in the lease at issue gave the lessor the option of receiving the royalty share “in kind” “without costs into pipelines” or to be paid “in cash” “the market value thereof.”²⁹⁸ The lessor elected to receive the royalty in cash, and the lessee, before paying royalty to the lessor, deducted the costs of compression, dehydration, and gathering that took place on the leased premises.²⁹⁹ The court held that the compression, dehydration, and gathering costs were necessary to prepare the product for the pipeline. Thus, the court concluded that, under the implied covenant to market and under the language of the royalty clause, the lessee alone was required to bear all costs incurred to make the product marketable.³⁰⁰ Accordingly, the court held that the costs of compression, dehydration, and gathering on the leased premises could not be deducted from the lessor’s royalty payment.³⁰¹

After *Johnson*, *Wood*, and *TXO*, Oklahoma required that the lessee bear all costs required to obtain a marketable product, but permitted the costs incurred

292. *Id.* ¶ 12, 854 P.2d at 883.

293. *Id.* ¶ 6, 854 P.2d at 881.

294. *Id.*

295. *Id.* ¶ 9, 854 P.2d at 882.

296. 1994 OK 131, 903 P.2d 259.

297. *Id.*

298. *Id.* ¶ 4, 903 P.2d at 260 (emphasis omitted).

299. *Id.* ¶ 5, 903 P.2d at 260.

300. *Id.* ¶ 8, 903 P.2d at 261.

301. *Id.* ¶ 17, 903 P.2d at 263.

in transporting the product off the leased premises to be proportionately charged to a lessor. The Oklahoma Supreme Court modified this rule in *Mittelstaedt v. Santa Fe Minerals, Inc.*³⁰² At issue in *Mittelstaedt* were deductions from the lessor's royalty for the costs of transportation, dehydration, compression, and blending.³⁰³ The lease royalty clauses called for royalty to be paid on "gross proceeds[] at the mouth of the well."³⁰⁴ The *Mittelstaedt* court stated that the term "gross proceeds" suggested that the payment to the lessor was to be made without deductions and that a lease requiring payment of the "market value" referenced the contract price of the gas.³⁰⁵ The court noted that, generally, costs are classified as either production costs, which are never allocated, or post-production costs.³⁰⁶ The court stated that post-production costs may or may not be allocated based on the nature of the cost and their relation to the duties of the lessee created by the express language of the lease, the implied covenants, and industry custom.³⁰⁷

Although the "at the well" phrase was present in the royalty clause,³⁰⁸ the court did not address the sufficiency of the phrase in allocating post-extraction costs. Rather, the court completely ignored the language.³⁰⁹ The court held that, under the implied covenant to market, a lessee is required to transport the product in marketable form to the place of sale on the leased premises and that costs incurred to create a marketable product may not be allocated to the lessor's royalty.³¹⁰ Costs are incurred to obtain a marketable product if the costs are necessary to prepare the product for market.³¹¹ Additionally, the court stated that costs incurred off the leased premises "must be examined on an individual basis to determine if they are within the class of costs shared by a royalty interest."³¹² The determination of whether the costs incurred off the leased premises fall within the lessee's duty to market is based on an examination of the language of the leases and custom and usage in the industry.³¹³

302. 1998 OK 7, 954 P.2d 1203.

303. *Id.* ¶ 1, 954 P.2d at 1204-05.

304. *Id.* ¶ 11, 954 P.2d at 1206.

305. *Id.* ¶ 9, 954 P.2d at 1206 (citing *Helmerich & Payne, Inc. v. State ex rel. Comm'rs of the Land Office*, 1997 OK 30, ¶ 12, 935 P.2d 1179, 1181; *Pioneer Tel. Coop. Inc. v. Okla. Tax Comm'n*, 1992 OK 77, 832 P.2d 848).

306. *Id.* ¶ 26, 954 P.2d at 1209.

307. *Id.*

308. *Id.* ¶ 11, 954 P.2d 1206.

309. *Id.*

310. *Id.* ¶¶ 11-20, 954 P.2d at 1206-08.

311. *Id.* ¶ 12, 954 P.2d at 1206.

312. *Id.* ¶ 19, 954 P.2d at 1208.

313. *Id.* ¶ 26, 954 P.2d at 1209.

Rather than finding that post-extraction costs are never allocable to a lessor's royalty, the court held:

[A] royalty interest may bear post-production costs of transporting, blending, compression, and dehydration, when the costs are reasonable, when actual royalty revenues increase in proportion to the costs assessed against the royalty interest, when the costs are associated with transforming an already marketable product into an enhanced product, and when the lessee meets its burden of showing these facts.³¹⁴

In other words, the court held the lessee responsible for all costs incurred in making the product marketable, but permitted the proportional allocation of costs incurred after obtaining a marketable product upon the lessee's satisfaction of the stated requirements. If the lessee chooses to take a marketable product further downstream, however, the lessee must pay royalty on the greater amount of either the proceeds of the sale, less the post-extraction costs that enhance an already marketable product, or on the value of the product in its first marketable-condition. This is similar to the analysis applied by the Oklahoma Supreme Court to affiliate sales. According to *Howell v. Texaco Inc.*, when a lessee sells gas to an affiliate, the lessee must pay royalty on the greater of the work-back calculation, based on the price the affiliate receives on resale of the gas less allowable deductions, or on the prevailing arm's-length price of marketable gas determined by comparable sales when the gas is sold to the affiliate.³¹⁵

According to the court's holding in *Mittelstaedt*, royalty valuation occurs when a marketable product is obtained and the lessee must bear all costs incurred in obtaining a marketable product. Therefore, no post-extraction costs may be deducted from a lessor's royalty payment until a marketable product is obtained. Once a product is in marketable form, a lessee may deduct post-extraction costs if the lessee proves that the costs were incurred to enhance an already marketable product, were reasonable, and that resulting royalty revenues increased in proportion with the costs assessed against the royalty interest.³¹⁶ Under this analysis, the court concluded that the post-extraction costs at issue were necessary to make the product marketable.³¹⁷ Thus, the costs were not deductible from the lessor's royalty, and the lessee was required to bear the cost.³¹⁸

314. *Id.* ¶ 30, 954 P.2d at 1210.

315. *Howell v. Texaco Inc.*, 2004 OK 92, 112 P.3d 1154.

316. *Mittelstaedt*, 1998 OK 7, 954 P.2d at 1208-09.

317. *Id.* ¶ 29, 954 P.2d at 1210.

318. *Id.*

Although the court's holding is seemingly at odds with the ruling in *Johnson*, the court stated that its previous ruling in *Johnson* remains viable.³¹⁹ This is because the court stated that its holding in *Mittelstaedt* does not require that the lessee bear all costs incurred in transporting gas in marketable condition to a distant market when there is no market available at the wellhead.³²⁰ To the extent that *Johnson* is still good law, the court has yet to clarify when it will actually apply. It is possible that when the court refers to transportation costs it is distinguishing off-lease gathering from off-lease pipeline transportation, with only the latter being deductible.

Although the Oklahoma courts have consistently held that costs incurred to obtain a marketable product are not allocable to a lessor's royalty interest, the Oklahoma Supreme Court dramatically diverged from this rule regarding overriding royalty in *XAE Corp. v. SMR Property Management Co.*³²¹ At issue in *XAE* were deductions taken from an overriding royalty interest for gathering, processing, and compression costs.³²² The overriding royalty was created by assignment rather than reserved in a lease.³²³ The assignment provided for a share of production "free and clear of all costs and expenses whatsoever"³²⁴ The Oklahoma Supreme Court stated that the lessee's duty to deliver gas in marketable form arises from the lessee's implied duty in an oil and gas lease to market the product.³²⁵ The court held that the implied duty to market did not apply to an overriding royalty interest created by an assignment absent language creating that obligation.³²⁶ Therefore, the owner of the overriding royalty does not benefit from the implied covenants in an oil and gas lease and the only obligation of the lessee is to deliver the gas in-kind when extracted.³²⁷ Thus, the Oklahoma Supreme Court adopted the at-the-well rule regarding an overriding royalty in *XAE*. Consequently, the lessee may deduct post-extraction costs against overriding royalties.³²⁸

In *XAE*, the Oklahoma Supreme Court rejected the Colorado Supreme Court's holding in *Garman v. Conoco, Inc.* that the implied covenant to market extends to overriding royalty because nonworking interests have no control over the marketing decisions of the lessee.³²⁹ Thus, according to *Garman*, a

319. *Id.* ¶ 13, 954 P.2d at 1207.

320. *Id.*

321. 1998 OK 51, 968 P.2d 1201.

322. *Id.*

323. *Id.* ¶ 1, 968 P.2d at 1202.

324. *Id.* ¶ 2, 968 P.2d at 1202.

325. *Id.* ¶ 32, 968 P.2d at 1208.

326. *Id.*

327. *Id.*

328. *Id.* ¶ 31, 968 P.2d at 1208.

329. *Id.* ¶¶ 18-22, 968 P.2d at 1205-06 (citing *Garman v. Conoco, Inc.*, 886 P.2d 652 (Colo.

lessee may not deduct post-extraction costs incurred in obtaining a marketable product from an overriding royalty payment, presumably even if “at the well” language is present in the royalty clause.³³⁰ Pursuant to the Oklahoma Supreme Court’s holding in *XAE*, however, all costs incurred after severance from the wellhead may be deducted from overriding royalty regardless of the absence of “at the well” language in the assignment creating the interest.³³¹ The court reasoned that the lessee’s duty to bear costs incurred in obtaining a marketable product pursuant to the implied covenant to market arises out of the oil and gas lease and therefore is not applicable to an overriding royalty that is carved out of the working interest and created by an assignment.³³²

2. Oklahoma Royalty Valuation

In Oklahoma, royalty valuation occurs when a marketable product is obtained. The Oklahoma rule requires that the lessee bear all costs incurred in obtaining a marketable product pursuant to the implied covenant to market, and a lessee cannot deduct post-extraction costs from a lessor’s royalty if the costs were necessary to prepare the product for market. Some of the language in Oklahoma cases seems to treat marketability as a question of law rather than of fact.³³³ This is evidenced by the court’s holding in *TXO* that “the costs for compression, dehydration and gathering” were not deductible because “such processes are necessary to make the product marketable,”³³⁴ as well as the court’s conclusion in *Wood* that compression costs cannot be deducted from a lessor’s royalty.³³⁵ Both cases concluded that the costs were necessary to create a marketable product without citing to any factual findings in this regard.³³⁶

Further evidence that Oklahoma seems to treat marketability as a question of law is the court’s statement in *Mittelstaedt* that “[c]learly, compression on

1994)).

330. *Id.* ¶ 21, 968 P.2d at 1206 (quoting *Garman*, 886 P.2d at 659).

331. *Id.* ¶ 31, 968 P.2d at 1208.

332. *Id.* ¶¶ 24-25, 968 P.2d at 1207.

333. Anderson, *supra* note 2, at 664-69.

334. *TXO Prod. Corp. v. State ex rel. Comm’rs of the Land Office*, 1994 OK 131, ¶ 17, 903 P.2d 259, 263; *see also Mittelstaedt v. Santa Fe Minerals, Inc.*, 1998 OK 7, ¶ 15, 954 P.2d 1203, 1213-14 (Opala, J., dissenting) (stating that *TXO* “err[s] in treating marketability as a question of law rather than one of fact” (emphasis omitted)).

335. *Wood v. TXO Prod. Corp.*, 1992 OK 100, ¶ 9, 854 P.2d 880, 882; *see also Mittelstaedt*, ¶ 15, 954 P.2d at 1213-14 (Opala, J., dissenting) (stating that *Wood* “err[s] in treating marketability as a question of law rather than one of fact” (emphasis omitted)); Anderson, *supra* note 2, at 665 (explaining that *Wood* treated marketability as a question of law).

336. *See TXO*, 1994 OK 131, 903 P.2d 259; *Wood*, 1992 OK 100, 854 P.2d 880; *see also* Anderson, *supra* note 2, at 665-66.

the leased premises to push marketable gas into the purchaser's pipelines is a cost not allocated to the royalty interest.³³⁷ Again, the court seems to simply conclude that compression is never deductible as a matter of law because no factual findings are cited. The court in *Mittelstaedt* ultimately concluded that the compression, dehydration, and blending costs at issue in the case were necessary to obtain a marketable product without citing any factual findings regarding the availability of a market for the product before the post-extraction costs were incurred.³³⁸ Thus, the Oklahoma rule does not base the deductibility of post-extraction costs on a factual inquiry into whether a marketable product has been obtained.³³⁹ Rather, the Oklahoma rule disallows the deduction of compression, dehydration, gathering, and blending costs because the court appears to deem them as being necessary to obtain a marketable product as a matter of law.³⁴⁰ Notwithstanding its language, the Oklahoma Supreme Court may intend for marketability to be a question of fact. Whether a product is or is not in a marketable condition inherently seems to be a question of fact.³⁴¹ Of course, even if the court later clarifies that marketability is a question of fact, the lessee will likely continue to carry the burden of proof on this issue.³⁴²

The Oklahoma rule allows for reasonable post-extraction costs incurred to enhance an already marketable product to be deducted from a lessor's royalty if the lessee proves that the proceeds of the sale of the enhanced gas, less the deductions for costs incurred to enhance the gas, are greater than the value of the product when it first became marketable as determined by comparable sales.³⁴³ In other words, if the lessee enhances an already marketable product, the lessee must compare the work-back value of the royalty with comparable sales and pay royalty on the greater of the two amounts. Moreover, the Oklahoma rule allows for the deduction of transportation costs if there is no market available on the leased premises and the costs are incurred to transport already marketable gas to a distant market off of the leased premises.³⁴⁴ It appears, however, that the court differentiates between off lease gathering and

337. *Mittelstaedt*, ¶ 29, 954 P.2d at 1210 (citing *Wood*, 1992 OK 100, 854 P.2d 880).

338. *Mittelstaedt*, ¶¶ 20-26, 954 P.2d at 1208-09.

339. *Id.*; see also *id.* ¶ 15, 954 P.2d at 1213-14 (Opala, J., dissenting) (criticizing the court for "arbitrarily declar[ing] certain costs as necessary to produce a marketable product" without any factual inquiry).

340. *Mittelstaedt*, ¶ 29, 954 P.2d at 1210; *TXO*, ¶¶ 12-17, 903 P.2d at 262-63; *Wood*, ¶ 9, 854 P.2d at 882; see also Anderson, *supra* note 2, at 665-66.

341. See *Mittelstaedt*, ¶ 15, 954 P.2d at 1213-14 (Opala, J., dissenting).

342. See *id.* ¶ 30, 954 P.2d at 1210 (majority opinion) (holding that post-production costs can be deducted from royalty "when the lessee meets its burden of showing" certain facts).

343. *Id.* ¶¶ 29-30, 954 P.2d at 1210.

344. *Johnson v. Jernigan*, 1970 OK 180, 475 P.2d 396.

off lease pipeline transportation, with the latter being deductible as transportation costs.³⁴⁵ Additionally, the lessee cannot deduct costs to transport the product if the point of sale is on the leased premises.³⁴⁶ If there is an available market on the leased premises, but the lessee sells the product further downstream the lessee can possibly deduct transportation costs to a distant market.³⁴⁷ The lessee, however, must prove that the product was already in a marketable form, that the costs were reasonable, and that the proceeds of the sale of the enhanced gas, less the deductions of reasonable costs incurred to enhance the gas, are greater than the value of the product when it first became marketable as determined by comparable sales.³⁴⁸

Furthermore, Oklahoma's rule regarding overriding royalty interest diverges drastically from Oklahoma's rule regarding royalty interest. Unlike Colorado and perhaps other jurisdictions, Oklahoma applies a different rule to overriding royalty than it does to lease royalty.³⁴⁹ The Oklahoma rule disallows deductions from a lessor's royalty of costs incurred in obtaining a marketable product.³⁵⁰ In contrast, a lessee may deduct all post-extraction costs from an overriding royalty payment. Thus, the Oklahoma courts have consistently applied the marketable-product rule to lease royalty interests, however, regarding overriding royalty, the at-the-well rule applies.

IV. A Comparison of the Five States' Rules and Their Inherent Problems

After examining Arkansas, Kansas, Oklahoma, Colorado, and West Virginia's case law, it is apparent that absent a lease provision to the contrary, all five states require that the lessee—pursuant to the implied covenant to market—obtain a marketable product and to bear all costs incurred in doing so. Accordingly, royalty valuation in all five states occurs at the point a marketable product is obtained. The five rules, however, vary as to the exact point at which a marketable product is obtained. Under the Arkansas, Kansas, and Oklahoma rules, a marketable product is one that is in marketable condition, although some components of transportation, such as compression in Kansas, and compression and gathering in Oklahoma, are not deductible. On the other hand, the Colorado rule defines a marketable product as one that is in a marketable condition as well as at a market location. Further, the West Virginia rule seems to equate marketability with the point of sale; thus, a

345. *Wood*, ¶¶ 6-9, 854 P.2d at 881-82.

346. *Id.*

347. *Mittelstaedt*, ¶ 29, 954 P.2d at 1210.

348. *Id.*

349. *See XAE Corp. v. SMR Prop. Mgmt. Co.*, 1998 OK 51, 968 P.2d 1201.

350. *Id.* ¶ 32, 968 P.2d at 1208.

product is not marketable until it is sold. Because of the variations as to when a marketable product is obtained, the deductibility of post-extraction costs differs under each state's rule.

Additionally, the requirements that the lessee must prove to deduct post-extraction costs incurred after a marketable product is obtained varies from state-to-state, although Colorado and Oklahoma are in basic agreement on this matter. Furthermore, the rules differ regarding the treatment of "at the well" terminology, the lessee's obligation to bear transportation costs, and the treatment of marketability as either a question of law or fact. In the following section, the five states' rules are compared and contrasted to highlight the variations in the states' application of the marketable-product rule. In addition, a few possible problems inherent in the rules are discussed.

A. Transportation Costs, "At the Well" Terminology, and Post-Extraction Costs Incurred to Enhance an Already Marketable Product

Three of the five marketable-product states may allow for the deduction of some transportation costs incurred in transporting a marketable product to a distant point of sale when no market is available on the leased premises. Although, the Arkansas, Kansas, and Oklahoma rules allow for the deduction of these costs, Kansas is the only state that clearly ties the rule to the "at the well" phrase in a lease royalty clause. Pursuant to the Kansas rule, the "at the well" phrase provides the location for royalty valuation, even though it is insufficient to allocate all post-extraction costs to a lessor.³⁵¹

Conversely, the Arkansas and Oklahoma Supreme Courts failed to expressly discuss the "at the well" phrase present in the lease royalty clauses. The Arkansas and Oklahoma courts failure to address the "at the well" phrase is not in keeping with the historical interpretation of royalty clauses according to contract principles, concentrating on the lease language and the intent of the parties.³⁵² Thus, while the courts came to the correct conclusion regarding the deductibility of transportation costs, both courts failure to discuss the "at the well" phrase in the royalty clause leaves the effect of this terminology open to consideration.

Regarding costs incurred to enhance or transport an already marketable product, Kansas and Oklahoma have reached different conclusions as to what the lessee is required to prove. Pursuant to the Kansas rule, a lessee may deduct costs incurred to enhance a marketable product if the lessee proves that

351. *Sternberger v. Marathon Oil Co.*, 894 P.2d 788, 799-801 (Kan. 1995).

352. *Mittelstaedt*, ¶ 18, 954 P.2d at 1215 (Opala, J., dissenting); Anderson, *supra* note 67, at 572; Poitevent, *supra* note 10, at 758.

the costs were reasonable.³⁵³ Pursuant to the Oklahoma rule, a lessee may deduct costs incurred to enhance or transport an already marketable product if the lessee proves that the product was already in a marketable form, if the costs were reasonable, and if royalty revenues increase in proportion with the costs assessed against the royalty.³⁵⁴ What this likely means is that the lessee may deduct reasonable post-extraction costs incurred to enhance an already marketable product if the lessee shows that the proceeds of sale of the enhanced product, less the deductions for costs incurred to enhance the product, are greater than the value of the product when it first became marketable as determined by comparable sales. If the proceeds less deductions are not greater, then the lessee must pay royalty on the value of the product when it first became marketable—as may be determined by comparable sales. Thus, regarding the deductibility of post-extraction costs incurred to transport or enhance an already marketable product, the Oklahoma rule places requirements on the lessee that are more stringent than the Kansas rule that only requires the lessee to prove the costs are reasonable.

Both the Colorado rule and the West Virginia rule disallow deduction of transportation costs incurred to transport a product to the first market location—apparently without regard to distance. This is because the Colorado rule defines “marketable product” as including both the physical condition of the gas and the availability of a commercial market.³⁵⁵ Thus, the lessee is required to bear all costs incurred in conditioning the gas for market, as well as transporting the gas to a market location. On the other hand, the West Virginia rule, announced in *Tawney*, seems to equate marketability with the point of sale.³⁵⁶ Accordingly, the product, in effect, is not marketable until the point of sale, and the lessee may not deduct any costs incurred in obtaining a marketable product or transporting the product to the point of sale.

Both the Colorado and West Virginia rules depart from the traditional rule, and from the rule adhered to in Oklahoma, Kansas, and Arkansas, that costs to transport the product to a distant market are distinguishable from other costs incurred in preparing gas for market.³⁵⁷ The Colorado and West Virginia rules

353. *Sternberger*, 894 P.2d at 801.

354. *Mittelstaedt*, ¶ 30, 954 P.2d at 1210.

355. *Rogers v. Westerman Farm Co.*, 29 P.3d 887, 904 (Colo. 2001) (quoting *Garman v. Conoco, Inc.*, 886 P.2d 652, 660 n.26 (Colo. 1994)).

356. *Estate of Tawney v. Columbia Natural Res., L.L.C.*, 633 S.E.2d 22 (W. Va. 2006); see also *supra* Part III.D.

357. *Rogers*, 29 P.3d 887 (holding transportation costs are not distinguishable under Colorado law); *Tawney*, 633 S.E.2d 22 (holding transportation costs are not distinguishable under West Virginia law).

place a heavy burden on the lessee by requiring him to bear the costs of transportation to a distant market.³⁵⁸

Pursuant to either the Colorado or West Virginia rule, the “at the well” phrase does not provide the location for royalty valuation. The Colorado Supreme Court came to this conclusion after finding the “at the well” phrase “silent.”³⁵⁹ The court’s conclusion is inconsistent with the contract principles historically applied to royalty clauses.³⁶⁰ The court stated that the language was subject to more than one interpretation, but rather than finding that the language was ambiguous and trying to ascertain the intent of the parties, the court concluded that the “at the well” phrase was completely silent as to cost allocation respecting both condition and location.³⁶¹

In *Tawney*, the West Virginia Supreme Court did not find the “at the well” terminology silent. Rather, the *Tawney* court concluded that the language did not provide the location for royalty valuation after finding the language ambiguous.³⁶² Before the West Virginia Supreme Court’s decision in *Tawney*, the court had stated in dicta in *Wellman* that the “at the well” phrase and similar terminology was indicative of the parties’ intent to allocate transportation costs.³⁶³ The *Wellman* court also suggested that a lessee could possibly deduct post-extraction costs for transportation if the lessee proved that they were actually incurred and reasonable.³⁶⁴ However, the possibility of deducting transportation costs did not last long. The rule laid down in *Tawney* made it clear that no costs may be allocated to a lessor until the point of sale, absent more specific lease language to the contrary.³⁶⁵ Thus, under the West Virginia rule, like the Colorado rule, the “at the well” phrase provides neither the condition nor the location of royalty valuation. The West Virginia rule however, is based on the language being ambiguous rather than silent like the Colorado rule. The *Tawney* court’s determination that the “at the well” phrase was ambiguous,³⁶⁶ and the *Rogers* court’s determination that the language is silent,³⁶⁷ beg the question of what language is sufficient to deduct transportation costs.

358. See Marshall, *supra* note 6, at 258.

359. *Rogers*, 29 P.3d at 897.

360. Anderson, *supra* note 67, at 549; see also Owen L. Anderson, Rogers, Wellman, and the New Implied Marketplace Covenant, ROCKY MTN. MIN. L. FOUND. SPECIAL INST. ON PRIVATE OIL & GAS ROYALTIES (2003).

361. *Rogers*, 29 P.3d at 897.

362. Estate of Tawney v. Columbia Natural Res., L.L.C., 633 S.E.2d 22, 29 (W. Va. 2006).

363. Wellman v. Energy Res., Inc., 557 S.E.2d 254, 264-65 (W. Va. 2001).

364. *Id.*

365. *Tawney*, 633 S.E.2d at 29.

366. *Id.*

367. *Rogers v. Westerman Farm Co.*, 29 P.3d at 887, 896 (Colo. 2001).

The Colorado and West Virginia rules create an incentive for the lessee to focus on avoiding transportation costs, perhaps to the detriment of both parties. In particular circumstances, lessees will be enticed to seek a market based on the lowest possible cost to transport the product rather than a market with the best purchase price. Of course, this is contrary to the implied covenant to market, which historically required the lessee to market the product and obtain the best possible price and terms.³⁶⁸ Moreover, the extension of the lessee's duty encourages the creation of markets near or at the wellhead, regardless of whether the location is the most efficient marketplace.³⁶⁹ Although the rule, in theory, was intended to provide more certainty and uniformity in royalty valuation—thus reducing disputes over post-extraction costs—the application of the rule could potentially result in more litigation requiring a determination of whether the lessee was complying with the implied covenant to market and seeking to obtain the best possible price and terms. Accordingly, requiring the lessee to bear transportation costs may actually complicate, rather than simplify, royalty valuation, by giving the lessee an incentive to avoid transportation costs; consequently subjecting the courts to the task of determining if lessees are acting in good faith in compliance with the implied covenant to market.

While both the Colorado and West Virginia rules disallow the deduction of costs incurred to transport a product in a marketable condition to a distant location where no market is available on the leased premises, the two rules differ regarding costs incurred to enhance an already marketable product. The Colorado rule defines a marketable product as referring to both condition and location.³⁷⁰ Thus, a lessee is required to bear all costs incurred in obtaining a product in a marketable condition as well as transporting the product to a market location.³⁷¹ However, after the product becomes marketable, costs incurred to enhance or transport the product may be deducted from the lessor's royalty payment so long as the lessee proves that they are reasonable and that the lessor has benefited from the enhancement.³⁷² In contrast, the West Virginia rule requires that the lessee bear all costs incurred up to the point of sale.³⁷³ Thus, post-extraction costs are never deductible from a lessor's royalty payment.³⁷⁴ Accordingly, the West Virginia rule expands the implied covenant

368. Anderson, *supra* note 67, at 572.

369. Marshall, *supra* note 6, at 254.

370. *Rogers*, 29 P.3d at 904 (quoting *Garman v. Conoco, Inc.*, 886 P.2d 652, 660 n.26 (Colo. 1994)).

371. *Id.* at 906.

372. *Id.*

373. *Estate of Tawney v. Columbia Natural Res., L.L.C.*, 633 S.E.2d 22, 29 (W. Va. 2006).

374. *Id.*

to market even more than the Colorado rule. This places an undue burden on the lessee and diverges from the traditional rule by requiring the lessee to bear all post-extraction costs, including transportation costs, regardless of the condition of the product or the presence of a market.

Although the West Virginia Supreme Court was attempting to put a more stringent requirement on the lessee to bear costs and to protect the lessor from improper deductions, the court did neither. This is because the West Virginia rule's requirement that a lessee bear all costs incurred until the point of sale may encourage producers to sell at or near the wellhead.³⁷⁵ This is contrary to the implied covenant to market, which historically required the lessee to diligently market the product and obtain the best possible price and terms.³⁷⁶ The practice of selling at or near the wellhead at arm's length would comply with the West Virginia rule because the lessee would incur all costs up to the point of sale.³⁷⁷ This practice, however, could result in a lessee selling the gas inefficiently—perhaps even before the gas is actually in a marketable condition, thus contradicting the rule's purpose.

Further, burdening the lessee with all costs incurred until the point of sale could encourage lessees to sell to an affiliate at the wellhead to avoid paying royalty on the proceeds for a product that has been enhanced by large expenditures on the lessee's behalf. Although a lessee, pursuant to the West Virginia rule, is required to bear all costs until the point of sale,³⁷⁸ the lessee can possibly avoid paying royalty on the proceeds by selling the product, possibly in an unmarketable condition, at the well in an arms-length transaction or perhaps even to an affiliate. Of course, West Virginia could, and probably would, prevent this from occurring by adopting a rule similar to the Oklahoma rule in *Howell v. Texaco Inc.*³⁷⁹ Pursuant to *Howell*, when a lessee sells oil or gas to an affiliate, the lessee must pay royalty on the greater of the work-back calculation, based on the resale price of the gas from the affiliate, less any permissible deductions for the costs of processing, or on the prevailing arm's-length price of marketable gas determined by comparable sales when the gas is sold to the affiliate.³⁸⁰

B. Marketability as a Question of Fact or Law

In Kansas, Oklahoma, and West Virginia the determination of marketability, in certain respects, appears to be treated as a question of law,

375. Marshall, *supra* note 6, at 254.

376. Anderson, *supra* note 67, at 572.

377. Tawney, 633 S.E.2d at 29.

378. *Id.*

379. 2004 OK 92, 112 P.3d 1154.

380. *Id.* ¶¶ 18-22, 112 P.3d at 1159-60.

not fact.³⁸¹ Instead of a factual inquiry into the market conditions relevant to the gas in question and the existence of a market for the product, courts in these states seem to have declared certain costs necessary to obtain a marketable product.³⁸² Pursuant to the Kansas rule, it seems that compression costs are necessary to obtain a marketable product, and as such are not deductible from a lessor's royalty.³⁸³ The Oklahoma rule disallows the deduction of compression, dehydration, gathering, and blending costs because the court has deemed the costs are necessary to obtain a marketable product.³⁸⁴ The West Virginia rule disallows the deduction of all post-extraction costs to the point of sale.³⁸⁵ Thus, the Kansas, Oklahoma, and West Virginia rules arguably fail to base the determination of when a marketable product is obtained on a factual inquiry into the existence of a market.

The Colorado rule, however, properly treats marketability as a question of fact rather than one of law.³⁸⁶ The inquiry as to marketability pursuant to the Colorado rule is fact specific and turns solely on the market conditions relevant to the product in question and the existence of a market for the product.³⁸⁷

It remains unclear whether marketability is treated as a question of fact or law under the Arkansas rule.³⁸⁸

Oklahoma, Kansas, and Arkansas would do well to treat the marketability questions as fact questions, and this may well be their true intent. The determination of when a marketable product is obtained seems to be necessarily a question of fact. The courts probably intended to treat marketability as a question of fact; however, the courts' statements regarding the marketability of gas seem to treat marketability as a matter of law. Of course, even if a question of fact, the lessee would appear to bear the burden of proof—at least in Oklahoma.³⁸⁹

381. Anderson, *supra* note 2, at 664-69; *see also* Tawney, 633 S.E.2d at 29 (disallowing deductions prior to the point of sale).

382. Anderson, *supra* note 2, at 664-69.

383. *See* Gilmore v. Superior Oil Co., 388 P.2d 602, 606 (Kan. 1964).

384. *See* TXO Prod. Corp. v. State *ex rel.* Comm'rs of the Land Office, 1994 OK 131, ¶ 17, 903 P.2d 259, 263.

385. Estate of Tawney v. Columbia Natural Res., L.L.C., 633 S.E.2d 22, 29 (W. Va. 2006).

386. Rogers v. Westerman Farm Co., 29 P.3d 887, 906-09 (Colo. 2001).

387. *Id.*

388. *See* Hanna Oil & Gas Co. v. Taylor, 759 S.W.2d 563 (Ark. 1988).

389. Mittelstaedt v. Santa Fe Minerals, Inc., 1998 OK 7, ¶ 30, 954 P.2d 1203, 1210.

C. Oklahoma's Divergence from the Marketable-Product Rule Regarding Overriding Royalty Interests

Although Oklahoma's version of the marketable-product rule applies to royalty interests, the at-the-well rule applies to overriding royalty interests.³⁹⁰ Oklahoma differs in this respect from Colorado that treats lease royalty and overriding royalty in the same manner.³⁹¹ Although the Colorado Supreme Court's decision in *Garman* influenced the Oklahoma rule regarding the deduction of post-extraction costs from lease royalty, the Oklahoma Supreme Court rejected the *Garman* rule regarding overriding royalty, even though *Garman* dealt with an overriding royalty.³⁹² The court declined to apply the implied covenant to market to an overriding royalty and expressly rejected the Colorado Supreme Court's application of this duty to overriding royalty.³⁹³ The court reasoned that lessee's duty to bear all costs incurred in obtaining a marketable product, under the implied covenant to market, arises out of the oil and gas lease and that a lessee has no such duty under an assignment creating an overriding royalty interest.³⁹⁴

V. Conclusion

Royalty valuation disputes are a growing source of oil and gas litigation and the allocation of post-extraction costs is often the central issue in these disputes. The rules regarding the allocation of post-extraction costs are state-specific, and the states' rules vary dramatically regarding the costs that a lessee is allowed to deduct from a lessor's royalty payment. Furthermore, the sufficiency of "at the well" terminology in oil and gas leases varies from state to state. As a result, careful drafting of lease language is imperative to prevent or permit a lessee to deduct post-extraction costs from a lessor's royalty. This task, however, is often difficult because it remains unclear in many states what costs may be allocated to a lessor pursuant to a state's default rule, and what language is sufficient to allocate the costs that are otherwise not deductible pursuant to a state's default rule. Further, the lack of uniformity among the courts regarding post-extraction costs will continue to result in increased litigation as lessees remain unsure of what costs they may deduct.

The marketable-product approach requires that the lessee bear all costs incurred in obtaining a marketable product. This rule, however, as specifically

390. See *XAE Corp. v. SMR Prop. Mgmt. Co.*, 1998 OK 51, 968 P.2d 1201.

391. See *Garman v. Conoco, Inc.*, 886 P.2d 652, 653 (Colo. 1994).

392. *XAE*, ¶¶ 18-22, 968 P.2d at 1205-06.

393. *Id.*

394. *Id.* ¶ 32, 968 P.2d at 1208.

adopted and applied in Arkansas, Kansas, Colorado, Oklahoma, and West Virginia is not a uniform one, and in Colorado and West Virginia, the rule, as applied there, goes beyond what either Professor Merrill or Professor Kuntz envisioned insofar as requiring the lessee to deliver the gas to a market-location free of cost to the lessor. Furthermore, inconsistencies remain within the marketable-product jurisdictions concerning the determination of when a marketable product is obtained and what post-extraction costs, if any, may be deducted. Perhaps the Arkansas, Kansas, Colorado, Oklahoma, and West Virginia rules represent an attempt by the courts to reduce disputes over post-extraction costs by simply specifying certain types of activities, such as compression, as a production cost, which is similar to what the Texas at-the-well rule attempts to do by defining production as extraction. However well-intentioned, the five state variations of the marketable-product rule have resulted in a lack of uniformity which will continue to result in litigation as lessees remain unsure of what costs they may deduct.

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